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# THE INSURER'S RIGHT TO REIMBURSEMENT OF DEFENSE COSTS

Robert H. Jerry, II\*

In the various iterations of personal and commercial liability insurance policies commonly used in the United States, the insurer owes the policyholder two primary duties: a duty to indemnify the insured against liabilities the insured incurs to third parties for claims within the policy's coverage, and a duty to defend the insured against such claims when asserted in litigation brought against the insured.<sup>1</sup> The insurer's obligation under the duty to indemnify is bounded by virtue of the policy's monetary limits, but the insurer's undertaking under the duty to defend is rarely subjected to any similar limitation.<sup>2</sup> Thus, although the insurer has the certainty of knowing the maximum extent of its exposure under the indemnification obligation, the insurer faces uncertainty with respect to the potential magnitude of the costs of defending the insured against claims filed by third parties.

As a percentage of total claims costs, the expense of providing defenses to insureds is considerable. According to industry data, approximately fourteen percent of expenditures on claims is attributable to defense costs.<sup>3</sup> If this figure is

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1. See ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW § 111[a], at 729 (2d ed. 1996).

2. "Defense within limits" coverage provides the exception to the general rule. See *infra* notes 5-6.

3. See INSURANCE INFORMATION INSTITUTE, THE FACT BOOK 1999: PROPERTY/CASUALTY INSURANCE FACTS 57 (1998). This data, compiled for the Institute by Tillinghast-Towers Perrin, estimates that 46% of the dollars spent on liability claims (totaling approximately \$161 billion in 1995) compensate injured victims for losses (24% for actual economic loss and 22% for pain and suffering loss), 24% goes to administrative expenses, and 16% compensates claimants' lawyers. This implies that almost one-third of

correct, then more than \$20 billion is spent each year by U.S. insurers on defense costs. Thus, it is understandable that for much of the last two decades, insurers have devoted considerable attention to acquiring more control over such costs.<sup>4</sup> In the 1980s, during the most recent cycle that stressed the insurance industry's capacity to meet demand for coverage, the industry flirted briefly with so-called defense within limits ("DWL") policies (also sometimes called "self-consuming" or "burning limits" policies), under which the costs incurred in defending claims served to reduce, according to some sort of specified formula, the policy limits available for indemnification.<sup>5</sup> Regulatory and policyholder concern with the implications of making the duties to defend and to indemnify interdependent was significant, but these concerns essentially were tabled when industry interest in DWL coverage waned due to softening liability insurance markets.<sup>6</sup>

Another feature of industry practice has had considerably more staying power in recent years. Insurers have been much more aggressive in managing their relationships with attorneys and law firms retained to defend claims filed against policyholders. In this regard, insurer-imposed constraints on fees and billing practices have become widespread, often to the considerable consternation of the insurance defense bar.<sup>7</sup> Likewise, some insurers have aggressively promoted the use of in-house staff counsel to defend claims filed against policyholders, as

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total expenditures can be traced to the civil liability system, even though only one-third of claims mature into litigated suits and only 2% are resolved by court verdicts. *See id.* The 14% figure is larger than some earlier estimates. For other data, see Charles Silver, *Flat Fees and Staff Attorneys: Unnecessary Casualties in the Continuing Battle over the Law Governing Insurance Defense Lawyers*, 4 CONN. INS. L.J. 205, 216 n.39 (1997) (citing other sources placing figure for 1988 at approximately 9% of \$132 billion), and Robert I. McMurry, *Environmental Contamination, California*, 34 A.L.I.-A.B.A. 967, 996 n.5 (Aug. 16, 1995) (citing a 1992 study by the RAND Corporation calculating that nearly 90% of insurance industry expenditures in cleaning up toxic waste sites cover legal fees).

4. This Article focuses on defense costs as an element of total claims costs in liability insurance, but it should be noted that the insurance industry in recent years has addressed, with some success, the high level of overall legal spending. Relative to other industries, insurance firms spend a much larger percentage of total revenues on legal expenses, but total legal spending as a percentage of world-wide revenues declined from a median of .54% in 1992 to .32% in 1998 due to cost-control efforts. *See* Amanda Levin, *Insurers Decrease Overall Legal Spending*, NAT'L UNDERWRITER, LIFE & HEALTH/FIN. SERVS. EDITION, Jan. 25, 1999, at 38 (referring to Price Waterhouse Law Department Spending Survey).

5. *See* JERRY, *supra* note 1, § 111[j], at 762-63.

6. DWL policies are available in some discrete markets, but they are not currently in widespread use. For more discussion, see Shaun McParland Baldwin, *Legal and Ethical Considerations for "Defense Within Limits" Policies*, 61 DEF. COUNS. J. 89 (1994); Silver, *supra* note 3, at 235 n.93 ("Increasing numbers of liability insurance policies contain defense-within-limits provisions that eliminate the duty to defend when defense costs exceed a specified amount, usually the remaining policy limits.").

7. *See* Douglas R. Richmond, *The Business and Ethics of Liability Insurers' Efforts to Manage Legal Care*, 28 U. MEM. L. REV. 57 (1997); Silver, *supra* note 3, at 207.

opposed to retaining outside counsel.<sup>8</sup> The practice has not been without controversy, although it has been upheld in almost all cases where it has been challenged.<sup>9</sup> At the bottom line, insurers' interests in using staff counsel to defend claims is a function of the desire to acquire more control over and, ultimately, to reduce defense costs.

Asserting entitlement to reimbursement of defense costs incurred when defending claims outside coverage is one additional way insurers have sought to reduce the portion of total claims costs devoted to providing a defense. Although reimbursement of defense costs had been recognized as a possibility for at least a decade and had been approved in some cases, it was not until the California Supreme Court's July 1997 decision in *Buss v. Superior Court*<sup>10</sup> that any court either explored the right in detail or articulated a convincing theoretical rationale for it. Since then, the reimbursement issue has received much more attention.<sup>11</sup> Given the detailed discussion and ultimate approval of a limited reimbursement right in *Buss*, it is inevitable that insurers in many other jurisdictions will ask courts both to recognize the right and to extend its limited scope.<sup>12</sup>

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8. See, e.g., Leo J. Jordan & Hilde E. Kahn, *Ethical Issues Relating to Staff Counsel Representation of Insureds*, 30 TORT & INS. L.J. 25, (1994); Ronald E. Mallen, *Defense by Salaried Counsel: A Bane or A Blessing?*, 61 DEF. COUNS. J. 518 (1994); Silver, *supra* note 3, at 240-45.

9. See Silver, *supra* note 3, at 244-45.

10. 939 P.2d 766 (Cal. 1997).

11. See, e.g., William T. Barker, *Appellant's Brief: Arch-Angel Insurance Company v. Walter Raleigh: A Hypothetical Case on Recoupment of Defense Costs*, 19 INS. LITIG. RPTR. 533 (1997); Timothy S. Menter, *Expansion of the Duty to Defend in California*, 20 INS. LITIG. RPTR. 3, 6 (1998); Michael Sean Quinn, *Appellee's Brief: Arch-Angel Insurance Company v. Walter Raleigh: A Hypothetical Case on Recoupment of Defense Costs*, 19 INS. LITIG. RPTR. 588 (1997); Douglas R. Richmond, *Reimbursing Insurers' Defense Costs: Restitution and Mixed Actions*, 35 SAN DIEGO L. REV. 457, 458, 490 (1998); Dennis J. Wall, *Insured's Reimbursement of Insurers' Defense Expenses: Some Practical Steps*, 65 DEF. COUNS. J. 68 (1998). Some of the post-*Buss* interest focuses on ethical issues. See *infra* note 13. For earlier discussions of the issue, see generally Michael J. Brady & Susan H. Handelman, *Insurer's Right to Reimbursement: Neglected But Valuable Remedy*, 59 DEF. COUNSEL J. 547 (1992); Richard C. Giller, *A Further Explanation as to Why Insurers Are Entitled to Seek Reimbursement of Defense Costs*, 17 INS. LITIG. RPTR. 319 (1995); Richard C. Giller, *An Insurer's Right to Seek Reimbursement of Defense Costs: A National Perspective*, 17 INS. LITIG. RPTR. 132 (1995); Judith F. Goodman, *Can Insurers Recover Defense Costs When There is No Defense Obligation?*, N.Y. L.J., Feb. 4, 1992, at 1, and Brent E. Johnson, *A Policyholder's Perspective: A Reply to Richard Giller's Article "Insurer's Right to Seek Reimbursement of Defense Costs: A National Perspective"*, 17 INS. LITIG. RPTR. 252 (1995).

12. Texas probably will be one of the next state supreme courts to consider the issue; review was recently granted of an appellate court decision discussing the insurer's reimbursement right. See *Matagorda County v. Texas Ass'n of Counties County Gov't Risk Management Pool*, 975 S.W.2d 782 (Tex. Ct. App. 1998), *review granted* (June 24, 1999). The issue is likely to be raised in other jurisdictions as well. See Michael R. Brown & Thomas Bright, *Carriers Given Sledgehammer to Aid in Recovering Fees*, CORP. COUNS.,

This Article examines the theoretical justification for the insurer's asserted right to reimbursement of defense costs incurred in defending noncovered claims.<sup>13</sup> Part I sketches some details about the duty to defend which are necessary prerequisites to exploring any claim to a right of reimbursement. Part II discusses the rationale offered by most courts and commentators for recognizing the right to

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Oct. 1997, at 1 ("As a result of [Buss], insurance carriers throughout the country are likely to begin filing reimbursement lawsuits against their policyholders."); Richmond, *supra* note 11, at 458, 490 (observing that effect of *Buss* will extend beyond California's borders). Insurers are more likely to seek reimbursement in situations where the underlying lawsuit was complex and expensive to litigate. Insurers will be less likely to seek reimbursement from individuals under homeowners and other personal liability forms, given the lower returns and the ill-will such actions will generate among long-time, loyal customers, particularly those who will not understand why they must endure the personal cost of defending groundless, but noncovered claims. Yet the possibility of reimbursement actions in the personal lines cannot be ignored. See, e.g., Grinnell Mut. Reinsurance Co. v. Shierk, 996 F. Supp. 836 (S.D. Ill. 1998) (awarding insurer reimbursement for defense of noncovered claim under homeowners policy).

13. There are several things, all of which are important, that this Article does not do. First, it does not discuss, once the right is recognized, the amount of reimbursement to which the insurer is entitled. Is the insurer entitled to reimbursement of all defense costs? Or is the insurer only entitled to be reimbursed for costs incurred in defending claims for which there was never a potential of coverage? Under the latter approach, a claim may, in fact, be outside the coverage, but the insurer will be denied reimbursement if a potential for coverage existed at the time the claim was filed. This issue will be the subject of a separate article. Second, there is the matter of what procedures should be followed by the insurer when reserving the right to reimbursement. Generally speaking, the insurer should be explicit with the insured about its intentions to later seek reimbursement of defense costs as part of any claim that the allegations against the insured are outside the coverage. Explicit attention to the issue in the reservation of rights letter will moot any argument that the insurer lacks such rights by virtue of its failure to notify the insured about its intention to assert them. For more discussion of the practical steps to be followed in preserving the reimbursement right, see Douglas R. Richmond, *supra* note 11, at 505-07, and Staff of Theresa Flores & Associates, *Litigation Management as a Tool for Meeting the Burden of Proof Under Buss v. Superior Court*, MEALEY'S INS. L. WKLY., Jan. 12, 1998, at 15, and see generally Wall, *supra* note 11. Third, the insurer's assertion of the right to reimbursement puts a number of ethical concerns in the lap of defense counsel. This may create the need for additional disclosures by defense counsel at the time of the representation, but there is no bar under the applicable ethical rules to an insurer seeking to reserve unto itself the right to recover defense costs from the insured. For more discussion of the ethical ramifications of the reimbursement issue, see Jack T. Bangert & Bradley M. Dowd, *Ethical Implications for Defense Counsel When Insurers Seek Reimbursement*, 65 DEF. COUNS. J. 502 (1998); Kathleen E. Hegen & Randy W. Kuluva, What Ethical and Business Considerations Do Attorneys Face in Their Billing Practices? (Jan. 29, 1999) (unpublished manuscript, presented to the ABA Tort and Insurance Practice Section Insurance Coverage Litigation Committees). For a general discussion of the need for disclosure by defense counsel to the insured when the attorney is retained by the insurer to represent the insured, see William T. Barker, *Insurance Defense Ethics and the Liability Insurance Bargain*, 4 CONN. INS. L.J. 75, 88-92 (1997); Robert H. Jerry, II, *Consent, Contract, and the Responsibilities of Insurance Defense Counsel*, 4 CONN. INS. L.J. 153, 186-94 (1997).

reimbursement: under the law of restitution, the insurer who defends a noncovered claim bestows a benefit on the policyholder which, in justice, ought to be returned. This Part concludes that a reasoned argument can be made in support of the foregoing rationale, but that a reasoned argument can also be made to the contrary. Because the doctrinal principles of restitution are malleable and the implications of these principles are uncertain in application, restitution does not, by itself, provide a predictable basis for deciding whether the insurer has a reimbursement right for costs incurred in defending noncovered claims. Part III offers an alternative justification; it explains that the insurer's right should be analyzed in terms of contract law rules pertaining to interim settlements of unliquidated, disputed claims. These principles lead to the conclusion that the insurer does have a reimbursement right, assuming the insurer has taken proper steps to reserve it. The upshot of this conclusion is that courts that have grounded the reimbursement right in restitution principles have reached the correct result, but for tenuous reasons. In Part IV, this Article concludes by briefly addressing a different, but pivotal, question: whether, apart from the issue of the right being grounded in sound legal principles, the existence of such a right is desirable. This Part concludes that whenever insurers can reduce claims costs by pursuing the reimbursement right, their efforts should be encouraged, as this produces a liability insurance product most insureds desire *ex ante*.

## I. THE DUTY TO DEFEND

As between the duty to defend and the duty to indemnify, the more expansive duty is the duty to defend.<sup>14</sup> The essence of this common assertion is that the insurer is contractually obligated to defend even meritless suits that fall within the policy's coverage. Meritless claims, presumably, will be defeated, which means that the insurer's duty to indemnify such claims never will arise. In that sense, then, the duty to defend is broader; it is triggered in more situations than the duty to indemnify.

Yet in another sense, the common assertion that the duty to defend is broader than the duty to indemnify is misleading. Whatever the differences between the duties, the fact remains that both are directly linked to coverage. This is obvious with respect to the duty to indemnify; the insured need only pay judgments or settlements if the insured's liability arises out of a covered claim. Similarly, the insurer's contractual undertaking is to defend the insured against claims, even ones that are groundless or meritless, *if* the claims are within the scope of the policy's coverage.<sup>15</sup> With respect to any liability insurance product,

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14. See JERRY, *supra* note 1, § 111[a], at 729–30.

15. As a matter of contract, nothing short of the public policy considerations which render certain kinds of coverages invalid (e.g., no insurance for nonfortuitous losses, for criminal wrongdoing, etc.) prohibits an insurer from agreeing to defend any claim brought against an insured. This is not, however, what insurers agree to do in the liability forms commonly used today. In the "Homeowners Composite Form," the insurer promises to defend "[i]f a claim is made or a suit is brought against an 'insured' for damages because of 'bodily injury' or 'property damage' caused by an 'occurrence' to which this coverage

the insurer defends more claims than it indemnifies; after all, some plaintiffs who sue insureds will lose, and it necessarily follows that insurers will provide indemnification less frequently than they provide defenses. This, however, does not mean that the policy's *coverage* is broader with respect to the insurer's defense obligation, as compared to the insurer's indemnity obligation. The default principle is that an insurer need not defend—let alone indemnify—a claim against its insured that falls outside the policy's coverage.

Examining the conditional nature of the defense and indemnity obligations illuminates the differences between them. Whenever a contract is formed, a set of reciprocal rights and duties is created immediately.<sup>16</sup> The performance of these duties, however, is not always immediately due and owing because contracting parties commonly place conditions on performance obligations.<sup>17</sup> Sometimes conditions define the timing of the duty's performance;<sup>18</sup>

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*applies....*" Homeowners Composite Form, HO 00 03 04 91 (1990), *reprinted in* SUSAN J. MILLER & PHILIP LEFEBVRE, I MILLER'S STANDARD INSURANCE POLICIES ANNOTATED 199 (4th ed. 1997) (emphasis added) [hereinafter MILLER & LEFEBVRE]. In the standard commercial form, the insurer promises to defend and indemnify with respect to "'bodily injury' or 'property damage' to which this insurance applies...." Commercial General Liability (Occurrence) Form, CG 00 01 10 93 (1992), *reprinted in* I MILLER & LEFEBVRE, at 409 (emphasis added). For other examples, see Jerry, *supra* note 13, app. at 199–203.

16. "A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981). In Hohfeldian terms, the promisee's remedy exists when the promisee has a right to assert it, and this right is the corollary of the promisor's duty to perform; likewise, if the promisor has a duty to perform, some person has a right to enforce that performance. As explained by Professor Corbin, the most "convenient" definition of contract is "the legal relations between persons arising from a voluntary expression of intention, and including at least one primary right *in personam*, actual or potential, with its corresponding duty." Arthur L. Corbin, *Offer and Acceptance, and Some of the Resulting Legal Relations*, 26 YALE L.J. 169, 170 (1917). The right-duty correlation does not change when a contract is formed without an agreement or bargain, as is the case with contracts formed under reliance principles. In such circumstances, the promisee's (or in some instances a third party's) foreseeable change of position in reliance on a promise gives rise to the promisor's duty which the promisee, in turn, has a right to enforce. See RESTATEMENT (SECOND) OF CONTRACTS, §§ 17(2), 90 (1981).

17. "An obligor [under a contract] will often qualify his duty by providing that performance will not become due unless a stated event, which is not certain to occur, does occur. Such an event is called a condition. An obligor may make an event a condition of his duty in order to shift to the obligee the risk of its non-occurrence.... An obligor may also make an event a condition of his duty in order to induce the obligee to cause the event to occur." RESTATEMENT (SECOND) OF CONTRACTS, ch. 9, topic 5, Introductory Note, (1981).

18. Because "[p]erformance of a duty subject to a condition cannot become due unless the condition occurs or its non-occurrence is excused," RESTATEMENT (SECOND) OF CONTRACTS § 225(1) (1981), conditions are deployed to determine when a duty must be performed. To take a common example, if a seller promises to pay a broker a commission upon the closing of title pursuant to a land sales contract the broker has arranged, the satisfaction of the condition to the seller's duty to pay the commission—the occurrence of the closing—determines the time at which the seller's duty to the broker must be

at other times, a condition's satisfaction or nonsatisfaction will determine whether the duty is ever performed.<sup>19</sup> The insurer's duty to defend, which comes into existence immediately upon the formation of a contract between insurer and insured, is conditioned on, *inter alia*, the filing of a suit against the insured alleging claims *within coverage*.<sup>20</sup> Similarly, the insurer's duty to indemnify comes into existence immediately upon a contract's formation, but it is conditioned on the existence of a judgment against the insured on, or a settlement of, a claim *within coverage*. Thus, the contractual duties of defense and indemnity are coextensive in the sense that the contours of both duties are defined by the coverage provided in the contract, but the condition to the duty to defend will be satisfied in more instances than the condition to the duty to indemnify. This means that the duty to defend will become due and owing in more situations, but this does not alter the essential underlying relationship between the insurer's defense obligation and the existence of coverage.

Beyond the foregoing observations, much remains unclear. In large measure, this is because the typical liability insurance policy's language concerning the duty to defend is indefinite. The general point was made by

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performed. *See, e.g.*, *Indiana State Highway Comm'n v. Curtis*, 704 N.E.2d 1015, 1018 (Ind. 1998) (concluding that settlement agreement was not enforceable because condition precedent of getting state's approval was not satisfied); *Yeo v. State Farm Ins. Co.*, 555 N.W.2d 893, 895-96 (Mich. Ct. App. 1996) (stating that submission to examination under oath is condition to right of insured under property policy to bring suit against insurer upon the policy; suit cannot proceed until condition is satisfied).

19. To carry forward the illustration in the preceding note, the failure of the buyer, without any fault or cause by the seller, to proceed with the closing results in the non-occurrence of the condition—the closing—to the seller's duty to pay the commission to the broker. In that situation, the seller's duty to pay the commission will never become due and owing and will be discharged when it is clear that the condition cannot occur. *See* RESTATEMENT (SECOND) OF CONTRACTS § 225(2) (1981). *See, e.g.*, *Luttinger v. Rosen*, 316 A.2d 757, 758 (Conn. 1972) (finding that buyer's duty to purchase premises was discharged when condition that buyer obtain financing on particular terms was not met); *Irving v. Town of Clinton*, 711 A.2d 141, 142 (Me. 1998) (stating that nonoccurrence of condition, under snow plowing contract made contingent on approval of voters at annual town meeting, discharged parties from their duties under contract); *NGA #2 Ltd. Liab. Co. v. Rains*, 946 P.2d 163, 168 (Nev. 1997) (stating that vendor's duty to convey property was discharged when vendee failed to record parcel map by end of grace period for closing of escrow, where purchase agreement specified that time was of the essence).

20. Typically, duties are limited in scope. Indeed, the insurer under a policy covering liability for bodily injury and property damage losses does not undertake, at the time of contracting, to provide anything to the insured for liabilities arising out of, for example, the insured's nonperformance of contractual obligations to sell goods to third parties. For breach of contract claims (and many others), the insurer assumes no duties at all. But with respect to bodily injury and property damage losses, the insurer at the time of contracting incurs presently existing duties, albeit ones that are conditioned on the occurrence of some kind of accident that produces such losses. Thus, the insurer assumes a duty to defend covered claims; this duty comes into existence when the contract between insurer and insured is formed, but the performance of the duty is not due unless and until a covered claim is filed against the insured.



Professor Abraham over a decade ago, and it remains valid today: "Liability insurance policies often create obligations that are insufficiently detailed to govern insurer conduct completely. They appear to grant the insurer the privilege to settle claims but impose no obligation to do so, and they create a duty to defend the insurer without specifying its breadth or limits."<sup>21</sup> Specifically, standardized personal and commercial liability forms do not discuss the following: whether the duty to defend is triggered when the insurer's coverage responsibility is uncertain;<sup>22</sup> to what extent the insurer must defend when covered claims are asserted in a complaint along with noncovered claims (and whether the answer changes if the claims are inextricably connected to a common fact pattern);<sup>23</sup> to what extent the insurer enjoys a right to control the defense;<sup>24</sup> precisely who is the client of defense counsel appointed by the insurer to defend the insured, and to whom counsel owes his or her loyalties when interests diverge (or appear to have a potential for divergence);<sup>25</sup> whether the duty to defend runs through appeals;<sup>26</sup> how conflicts are resolved when the insurer and insured disagree about strategies to be employed in defending the claim against the insured;<sup>27</sup> to what extent the insurer must act, if at all, to protect noncovered interests of the insured (such as the insured's reputation interests);<sup>28</sup> and more. There is considerable case law, much of which is lacking in consistency, purporting to answer each of these questions, but the fundamental point is that policy language in the insurance contract does not resolve these questions.

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21. KENNETH S. ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY AND PUBLIC POLICY* 203 (1986).

22. See *id.* at 196 (noting that the "language of the standard liability policy provides almost no guidance" with respect to the insurer's duty when coverage is in doubt).

23. The general rule is that the insurer has a duty to defend all claims in a mixed action, but this answer is not required by the text of liability insurance forms in widespread use today. See *Buss v. Superior Court*, 939 P.2d 766, 775 (Cal. 1997) (explaining that the text of the insurance contract does not support the obligation to defend mixed actions in their entirety; rather, the court "can, and do[es], justify the insurer's duty to defend the entire 'mixed' action prophylactically, as an obligation imposed by law in support of the policy"); JERRY, *supra* note 1, § 111[c][4], at 737-40; JEFFREY W. STEMPEL, *LAW OF INSURANCE CONTRACT DISPUTES* § 9.03[c], at 9-66 to -69 (2d ed.1999).

24. See Jerry, *supra* note 13, at 163, 174-86; Charles Silver & Kent Syverud, *The Professional Responsibilities of Insurance Defense Lawyers*, 45 DUKE L.J. 255, 264-65 (1995).

25. For more discussion, see 1 ALLAN D. WINDT, *INSURANCE CLAIMS AND DISPUTES* (3d ed. 1995), § 4.19, at 215-18, William T. Barker, *The Tripartite Relationship: Who Is the Client and To Whom Does the Attorney Owe Ethical Duties?*, 20 INS. LITIG. RPTR. 729 (1998), and Symposium, *Liability Insurance Conflicts and Professional Responsibility*, 4 CONN. INS. L.J. 1 (1997).

26. For more discussion, see JERRY, *supra* note 1, § 113, at 776-79 and 1 WINDT, *supra* note 25, § 4.17, at 213-14.

27. See JERRY, *supra* note 1, § 114[d][2], at 809-14; 1 WINDT, *supra* note 25, § 4.20, at 218-26.

28. See *Western Polymer Tech., Inc. v. Reliance Ins. Co.*, 38 Cal. Rptr. 2d 78 (Ct. App. 1995); Jerry, *supra* note 13, at 159 n.26.

The same must be said with respect to the insurer's alleged right to reimbursement of defense costs for defending noncovered claims. Standardized liability forms speak neither for nor against such a right. Given the indefinite nature of the forms, this should come as no surprise. Indeed, because no text in the forms explains how or why an insurer might find itself defending noncovered claims in the first place, it should be anticipated that the insurer's right to be compensated for doing something beyond its contractual obligation receives no mention.

This discussion does not attempt to make perfect order out of the often perplexing array of judicial decisions regarding the scope of the duty to defend.<sup>29</sup> The crucial point to recognize for present purposes is that the insurer's reimbursement right, if it exists, rides "piggy back" on the duty to defend. That is, to the extent the insurance contract or insurance law doctrines<sup>30</sup> impose a duty on the insurer to provide a defense, the insurer, by necessity, has no right to reimbursement of defense costs; one cannot be reimbursed for doing something which is a part of one's obligation. Likewise, to the extent the insurer provides a defense in circumstances where none was owed, the insurer might have a right to reimbursement of defense costs. Because the duty to defend is linked to coverage, it follows that an insurer never can have a right to reimbursement of defense costs incurred in defending covered claims, but the insurer might have such a right with respect to the defense of noncovered claims in some circumstances.

The "piggy back" relationship between the duty to defend and the insurer's reimbursement right suggests a further point. To the extent the cases addressing whether and to what extent an insurer has a reimbursement right are inconsistent, the dissonance can sometimes be attributed not to disagreement over the reimbursement right *per se*, but to different approaches regarding the scope of the duty to defend.<sup>31</sup> Indeed, in situations where the insurer has defended the insured under a reservation of rights and now contests coverage for the sole purpose of clarifying the absence of an indemnity obligation, the scope of the insurer's defense obligation is irrelevant. Whether a defense obligation existed or not, the insurer defended; if the presence or absence of an indemnity is the only remaining issue, it does not matter whether the duty to defend never existed (i.e., was nonexistent *ab initio*) or whether a duty to defend existed at the moment the plaintiff's complaint in the underlying action was tendered but subsequently

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29. This is, to be sure, difficult territory. For other treatments, see generally JERRY, *supra* note 1, § 111, at 729–763, STEMPER, *supra* note 23, § 9.03, at 9-54 to -83, WINDT, *supra* note 25, §§ 4.01–4.45, at 145–293, and Richmond, *supra* note 11, at 459–72. Any treatment of the amount of reimbursement to which an insurer is entitled, *see supra* note 13, as distinguished from whether such a right exists, must examine the boundaries of the duty to defend in more detail.

30. Established principles of insurance law impose upon the insurer a duty to defend some claims even though the literal terms of the contract impose no such duty. *See infra* text accompanying notes 33–42.

31. The differences between the eight-corners rule and the potentiality rule are described *infra* text accompanying notes 33–42.

ceased to exist (e.g., was extinguished at the moment the court declared no coverage existed or the moment all potentially covered claims in the underlying action were dismissed). But to the insurer seeking reimbursement of defense costs, these finer points regarding the duty to defend matter greatly. If the insurer never had a duty to defend, the insurer reasonably can make a claim for reimbursement of all defense costs. If a duty to defend once existed but later was terminated, the insurer's recovery will be limited to costs incurred after the moment of termination—and if the insurer withdraws from the defense when the duty ceases to exist, the upshot will be that the insurer receives no reimbursement of costs incurred.<sup>32</sup>

The extent of the insurer's defense obligation has been addressed by judicial decision in every state,<sup>33</sup> and the results tend to organize themselves around two different rules. Many jurisdictions follow the so-called "eight-corners" rule (or "four-corners" rule, depending on who does the counting<sup>34</sup>), pursuant to which the allegations of the four corners of the complaint are compared to the terms (or "four more" corners) of the policy, and only if the allegations are within the policy's coverage does the insurer owe a defense.<sup>35</sup> No defense is owed for allegations outside coverage, and the insurer need not look beyond the four

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32. Determining how much reimbursement an insurer should receive, assuming a right to reimbursement exists, necessarily depends on determining the precise times during which the insurer defended even though it had no obligation to do so. A more detailed treatment of this question will be provided in a forthcoming article. *See supra* note 13.

33. *See* BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 5.02[a][C], at 176–99 (9th ed. 1998).

34. *See* EDO Corp. v. Newark Ins. Co., 898 F. Supp. 952, 961 (D. Conn. 1995) (applying "four corners" rule); National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc., 939 S.W.2d 139, 141 (Tex. 1997) (adhering to "eight corners" rule); Smith v. Katz, 595 N.W.2d 345, 350 (Wis. 1999) (adhering to "four corners" rule).

35. Some commentators and scholars describe this rule as the majority rule. *See* Ellen S. Pryor, *The Tort Liability Regime and the Duty to Defend*, 58 MD. L. REV. 1, 23 (1999) ("almost universally-used approach is the eight-corners rule"); Richmond, *supra* note 11, at 460 (eight-corners rule is "majority rule"). How one counts the cases depends on how one interprets them. In many cases, courts do not need to choose between the eight-corners rule and its primary competitor (the "potentiality rule") because both rules produce the same result. In such circumstances, one should be cautious about how one reads a judicial pronouncement that the allegations of the complaint are controlling, if the court is even that clear about the approach it is following in a particular case. Moreover, even if the potentiality rule is a minority rule, it has a substantial following—so substantial that it may, in fact, be the majority rule. *See* EUGENE R. ANDERSON ET AL., 1 INSURANCE COVERAGE LITIGATION § 3.3, at 118–19 (1997) ("Only a minority of courts have held that the court must confine its inquiry to facts alleged within the four corners of the complaint."); Pryor, *supra*, at 23 n.87 ("Most jurisdictions recognize a significant caveat to the complaint allegation rule. If the pleadings do not allege a potentially covered claim, but the insurer has knowledge of extrinsic facts that indicate a reasonable possibility of coverage, then the insurer has a duty to defend.").

corners of the allegations of the complaint when determining its defense obligation.<sup>36</sup>

The other approach is the so-called "potentiality rule," pursuant to which an insurer owes a duty to defend whenever a complaint is filed that raises a "potential for coverage."<sup>37</sup> The essence of the rule is that an insurer cannot ignore actual facts of which it is aware when evaluating whether it is obligated to defend the insured.<sup>38</sup> Instead, it "must look beyond the effect of the pleadings and must consider any facts brought to its attention or any facts which it could reasonably discover in determining whether it has a duty to defend."<sup>39</sup> If the known or reasonably discoverable facts "give rise to a 'potential of liability,' even if remote, under the policy," the insurer must defend.<sup>40</sup>

Notwithstanding the significant differences between the eight-corners rule and the potentiality rule, under either rule it is possible that an insurer might be obligated to commence a defense, even though it eventually will become apparent with the benefit of subsequently acquired information about the actual

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36. See, e.g., *Hawkeye-Security Ins. Co. v. Clifford*, 366 N.W.2d 489, 491 (S.D. 1985) ("If it is clear or arguably appears from the face of the pleadings in the action against the insured that the alleged claim, if true, falls within policy coverage, the insurer must defend. The review then ends...."); *Trinity Universal Ins. Co. v. Cowan*, 945 S.W.2d 819, 821-22 (Tex. 1997) (stating that if the complaint does not allege facts within coverage, the insurer need not defend); *General Cas. Co. of Wisconsin v. Hills*, 561 N.W.2d 718, 722-23 (Wis. 1997) (stating that insurer's defense obligation is predicated solely on allegations in the underlying action). For other citations to representative authority, see OSTRAGER & NEWMAN, *supra* note 33, § 5.02[a], at 161-71.

37. See, e.g., *Sanderson v. Ohio Edison Co.*, 635 N.E.2d 19, 23 (Ohio 1994) (requiring insurer to defend when insurer's duty to defend is not apparent from the pleadings but the allegations state a claim potentially or arguably covered); *First Bank of Turley v. Fidelity & Deposit Ins. Co. of Md.*, 928 P.2d 298, 302-04 (Okla. 1996) (stating that duty to defend is determined by underlying complaint and other pleadings and from other sources available to the insurer at the time the defense is tendered); *State Bankcorp, Inc. v. United States Fid. & Guar. Ins. Co.*, 483 S.E.2d 228, 233, 239 n.12 (W. Va. 1997) (stating that when in doubt, insurer must look beyond allegations of complaint and conduct an inquiry into facts to determine whether claims may be within coverage). For other citations to representative authority, see OSTRAGER & NEWMAN, *supra* note 33, § 5.02[a], at 171-91, and 1 WINDT, *supra* note 25, § 4.03, at 169-72.

38. See, e.g., *Loftin v. United States Fire Ins. Co.*, 127 S.E.2d 53, 56-59 (Ga. 1962) (requiring insurer to consider extrinsic facts in determining whether duty to defend exists); *Boston Symphony Orchestra, Inc. v. Commercial Union Ins. Co.*, 545 N.E.2d 1156, 1158-61 (Mass. 1989) (mandating that insurer give consideration to facts outside the complaint when it considers the allegations in the complaint to determine if coverage exists); *E-Z Loader Boat Trailers, Inc. v. Travelers Indem. Co.*, 726 P.2d 439, 443-44 (Wash. 1986) ("An insurance company is required to look beyond the allegations of the complaint if...the allegations are in conflict with facts known or readily ascertainable by insurer....").

39. *Spivey v. Safeco Ins. Co.*, 865 P.2d 182, 188 (Kan. 1993).

40. *Steinle v. Knowles*, 961 P.2d 1228, 1234 (Kan. 1998) (quoting *MGM, Inc. v. Liberty Mut. Ins. Co.*, 855 P.2d 77, 79 (Kan. 1993)).

facts, that no possibility existed at the time the complaint was filed that a claim within coverage would ever be proved. Moreover, information asymmetries alone may force the insurer to provide a defense, simply because it is unable to determine at the time the defense is tendered whether coverage exists.<sup>41</sup> Because it is inherent in both rules that insurers will defend some claims, or even entire suits, where coverage does not in fact exist, insurers should (at least in theory) charge and collect enough premiums to cover the costs associated with defending claims for which there is only "potential coverage" or with respect to which the eight-corners rule requires a defense even though no possibility of recovery exists under the actual facts. But the fact that insurers might collect premiums to fund the defenses of noncovered claims does not alter this basic point: When a defense is provided because coverage appeared possible but hindsight shows it never existed, or because in an eight-corners jurisdiction a noncovered claim is disguised in the pleadings as a covered claim, the insured receives a defense for a noncovered claim—even though the duty to defend is, like the duty to indemnify, directly linked to coverage.

Viewed from the perspective of the other policyholders who subsidize the receipt of defenses by some insureds for noncovered claims, the result is problematic. The appropriate question to ask is whether insureds (assuming they possess full information, i.e., full understanding of alternative products and their costs) would be interested in purchasing, and insurers would be interested in providing, liability insurance for defense of some noncovered claims. It seems fair to initially posit the following: (a) insureds expect to receive a defense to covered claims, including groundless or meritless claims within coverage; (b) insureds do not expect, *ex ante*, to receive defenses to noncovered claims;<sup>42</sup> and (c) insureds do

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41. See Richmond, *supra* note 11, at 466 ("An insurer's duty to defend is...determined at the outset of the litigation, when coverage issues may be unclear, or when coverage questions are unanswered.").

42. Expectation is, of course, different from desire. Insureds may desire such coverage *ex poste*, but this does not mean that they expected it *ex ante*. For example, when sued for loss-of-bargain damages in a contract action, an insured may wish that her liability insurer defend her, but the insured did not expect such coverage *ex ante* when purchasing protection for bodily injury and property damage liabilities.

The observation that insureds do not expect defenses to noncovered claims should not be understood to mean that insurance policies could not be drafted to create broader coverage with respect to defense than with respect to indemnity. For example, insureds might demand, and insurers might be willing to provide, insurance which does not indemnify insureds for judgments arising out of certain kinds of conduct (e.g., libel, slander, sexual harassment, some intentional torts), but which does provide a defense in the event the insured is sued for those kinds of conduct. In that event, the insured expects to be defended for claims that are outside the insurer's indemnity obligation; but in such instances, the claims are within the coverage under the defense obligation. Indeed, as Ellen Smith Pryor observes, such policies might be desirable (or "efficient" in the economic sense); the insured receives litigation insurance for frivolous claims of intentional conduct, but the insurer does not have to pay proceeds in the event such claims are ultimately proved valid. See Ellen Smith Pryor, *The Stories We Tell: Intentional Harm and the Quest for Insurance Funding*, 75 TEX. L. REV. 1721, 1729–30, 1746–60 (1997). Of course, under this

not expect to pay a premium to subsidize the receipt by other insureds of defenses to noncovered claims.<sup>43</sup> In the absence of empirical testing of the foregoing three points, the assertion that some insureds expect defenses of some noncovered claims cannot be disproved. Yet, under conditions of perfect competition, complete information among all market participants, and the absence of costs associated with product differentiation (because consumer understanding of alternative products would be perfect), it is fair to posit that if insurers announced they were collecting premiums from all insureds to enable the provision of defenses to some noncovered claims at the insurers' expense, some insureds would request the opportunity to purchase a more limited and less expensive coverage, where there is absolutely no entitlement to a defense for noncovered claims. Insureds that prefer the more limited coverage would, presumably, recognize that courts in some instances may require insurers to defend some noncovered claims, but these insureds likely would desire that insurers defending such claims obtain reimbursement of the costs of defense from those insureds after a court has determined that the claim was, in fact, outside the coverage.

Whatever products might be offered in perfectly efficient markets, and whatever choices insurance consumers would make in those markets, the fact remains that an insurer who successfully and cost-effectively recoups sums expended in defending noncovered claims reduces total claims costs. To the extent policyholders prefer not to provide cross-subsidies to insureds who are sued on noncovered claims, and to the extent policyholders prefer their premiums to be lower, reimbursement of defense costs should be favored by policyholders.<sup>44</sup>

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kind of insurance, some blameless insureds would end up subsidizing the defense costs of blameworthy insureds, but in some markets (e.g., a pool of similarly sized and situated business firms), individual market participants may be willing to bear the expense of subsidizing some bad actors to obtain the protection afforded by this kind of coverage.

43. This proposition follows from the preceding one. If an insured does not expect *ex ante* to receive a defense to a noncovered claim, the insured would neither expect nor desire to pay for the bestowal of this benefit to other similarly situated policyholders.

44. Until a robust reimbursement right is recognized, it is difficult to know whether insurers would, in fact, use accrued savings to offer a less expensive insurance product. Under conditions of sufficient competition, insurers that routinely defend noncovered claims without seeking reimbursement would have higher expenses, and therefore a more expensive insurance product; these insurers would, presumably, lose market share to insurers that develop a less expensive product. In the absence of competitive pressures, however, the effect of the availability of reimbursement on product price could be slight or nonexistent. In such an environment, one might anticipate that insurers would limit the pursuit of reimbursement to the unusual case where defense costs are very high, i.e., complex litigation, and the number of covered claims relative to noncovered claims is very low. Insurers would also decide whether to seek reimbursement based on considerations such as whether the insured still does business with the insurer (if the insured now purchases coverage from a competitor, the case is stronger for pursuing reimbursement) or whether the insured is thought to be a loyal customer whose prospect of continuing to pay premiums is high (the insurer is less likely to pursue reimbursement). In this environment, insurers would favor recognition of a reimbursement right simply to have it as an option, which might be pursued or not pursued on a random, ad hoc basis. In the

Indeed, one might speculate whether future iterations of the standard liability insurance policies will explicitly authorize the insurer to seek reimbursement of costs incurred in defending noncovered claims.<sup>45</sup> Unless the reimbursement right is provided by explicit policy text or by judicial rule (and is then consistently pursued by insurers), tension will exist between insureds that receive defenses for noncovered claims and the remainder of insureds. Indeed, it is safe to say that no individual policyholder who, when sued for noncovered claims, will voluntarily—let alone eagerly—embrace the opportunity to reimburse the insurer for the costs of defense rendered in the policyholder's behalf.

## II. RESTITUTION AS A JUSTIFICATION FOR THE INSURER'S RIGHT TO REIMBURSEMENT

Those who support the right to reimbursement of costs incurred in defending noncovered claims typically justify their position under the law of restitution.<sup>46</sup> Although restitution was the rationale for the holding in *Buss*<sup>47</sup> and

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absence of data, the argument cannot be resolved; in the absence of a recognized, reliable right of reimbursement, the absence of data is difficult to overcome.

45. In *Okada v. MGIC Indem. Corp.*, 823 F.2d 276 (9th Cir. 1987), where the Ninth Circuit applied Hawaii law, the court spoke approvingly of the insurer's right to reimbursement, but the case is distinguishable on the important ground that reimbursement was specifically authorized by the directors and officers liability policy at issue. See *id.* at 279, 282. Yet *Okada* does stand for the proposition that such a right explicitly set forth in the policy is valid and enforceable. This precedent will become more important if at some point in the future standardized policies are redrafted to authorize insurers to seek reimbursement for costs incurred in defending noncovered claims. In that event, the liability insurance contract will provide the theoretical justification for the reimbursement right, thus mooted the need for the analysis in this Article. See Richmond, *supra* note 11, at 495 (explaining that courts should give "an insurer that employs manuscript policies expressly conferring a right to reimbursement" such a right).

Why, then, have insurers not done this already in standardized policies? Several reasons are possible. First, the duty to defend language in the insuring agreement in the standardized forms has not undergone major structural change in recent decades. Notwithstanding numerous issues and problems that arise under the current indefinite language, see *supra* text accompanying notes 21–28, the form handles most cases without difficulty. Insurers' reluctance to make major changes that inevitably will be accompanied by uncertainty is understandable, particularly given the fact that such changes would affect almost every claim made against an insured. Also, any textual change mentioning the possibility of a defense being provided for noncovered claims must be worded, from the insurer's perspective, with extraordinary specificity; otherwise, the insurer risks, for example, a judicial interpretation extending the insurer's indemnity obligation to noncovered claims under a *contra proferentum* rationale. See JERRY, *supra* note 1, §§ 25A[b]–[c], at 129–36 (discussing *contra proferentum* and other principles of contract interpretation). If, however, insurers perceive substantial benefits to be gained from reimbursement claims, one should expect that the foregoing risks will not deter changes in standardized language clearly authorizing reimbursement.

46. See Richmond, *supra* note 11, at 496–505; Barker, *supra* note 11, at 543–52.

47. *Buss v. Superior Court*, 939 P.2d 776, 776–77 (Cal. 1997).

was the focus of a few other decisions discussing the theoretical underpinnings of the insurer's claimed reimbursement right,<sup>48</sup> grounding the insurer's reimbursement right—or the denial of the existence of such a right—in the law of

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Under the policy, the insurer does not have a duty to defend the insured as to the claims that are not even potentially covered. With regard to defense costs for these claims, the insurer has not been paid premiums by the insured. It did not bargain to bear these costs. To attempt to shift them would not upset the arrangement. The insurer therefore has a right of reimbursement that is implied in law as quasi-contractual, whether or not it has one that is implied in fact in the policy as contractual. As stated, under the law of restitution such a right runs against the person who benefits from 'unjust enrichment' and in favor of the person who suffers loss thereby. The 'enrichment' of the insured by the insurer through the insurer's bearing of unbargained-for defense costs is inconsistent with the insurer's freedom under the policy and therefore must be deemed 'unjust.'

*Id.* (citations omitted).

48. Most of the early cases discussing reimbursement, if they had an identifiable rationale, reasoned that an insurer could not recover costs expended in defending noncovered claims if it lacked an "understanding" with the insured or had not put the insured on notice in the reservation of rights letter that such reimbursement would be sought. *See, e.g., St. Paul Mercury Ins. Co. v. Ralee Eng'g Co.*, 804 F.2d 520, 522 (9th Cir. 1986) (noting that "the record does not reflect an understanding between the parties that Ralee would reimburse St. Paul if St. Paul eventually decided not to defend"); *North Atlantic Cas. & Sur. Ins. Co. v. William D.*, 743 F. Supp. 1361, 1366–67 (N.D. Cal. 1990) (stating that the "court can order the insured to reimburse the insurer only if there was an 'agreement or understanding' between the insured and insurer that there was a right to reimbursement"); *Walbrook Ins. Co. v. Goshgarian & Goshgarian*, 726 F. Supp. 777, 784 (C.D. Cal. 1989) (concluding that insured's acceptance of defense is adequate to show insured's "understanding" of insurer's right to reimbursement, even if insured objects to the reservation of rights); *Omaha Indem. Ins. Co. v. Cardon Oil Co.*, 687 F. Supp. 502, 505 (N.D. Cal. 1988) (stating that agreement or understanding is required and that insured's silence while acquiescing in insurer's provision of defense pursuant to explicit reservation is sufficient to enable insurer to recover defense costs), *aff'd*, 902 F.2d 40 (9th Cir. 1990); *Reliance Ins. Co. v. Alan*, 272 Cal. Rptr. 65, 69–70 (Ct. App. 1990) (stating that "the only theory for recovery of defense costs would be an agreement or understanding between [insured and insurer]"). Because the insurer could seek reimbursement only when, at a minimum, the insured was notified in advance of the insurer's intentions, insurers in some cases where the notice was obviously inadequate sought to establish a right to reimbursement based on the law of restitution. At least initially, the courts rejected this reasoning. *See Reliance Ins. Co.*, 272 Cal. Rptr. at 69–70; *Travelers Ins. Co. v. Leshner*, 231 Cal. Rptr. 791 (Ct. App. 1986). *Buss*, as discussed below, sustained the restitution theory, but in a factual context where not only notice but also an agreement contemplating the possibility of reimbursement existed. *See Buss*, 939 P.2d at 770 (describing notice given to insured and reimbursement agreement); *id.* at 784 n.27 (stating that insurer can reserve reimbursement right unilaterally; insured's agreement is not necessary, although it existed in the instant case anyway); *infra* text accompanying notes 83–105. For a survey of California cases on reimbursement, see Richmond, *supra* note 11, at 473–80.



restitution is problematic.<sup>49</sup> The malleability of the law of restitution is both its virtue and its curse. The malleability is virtuous in that it empowers courts to exercise discretion to reach just results, but flexibility's price is unpredictability; restitution's defined contours permit reasoned arguments both in favor of and in opposition to the insurer's reimbursement right. Thus, when the existence of the right is a question of first impression, as it will be in almost every jurisdiction in the United States, predicting whether a particular court will recognize the right is difficult. In probing restitution's limitations as the theoretical basis for the reimbursement right, this Part documents the need for a less pliant resolution of the question. In so doing, this discussion also introduces an alternative justification, which is more fully developed in Part III.

#### *A. The General and Malleable Principles of Restitution*

Restitution is both a substantive theory and a remedy.<sup>50</sup> It resides in the interstices between tort and contract and it furthers both corrective<sup>51</sup> and

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49. Because the doctrine of equitable subrogation, like restitution, serves justice-promoting purposes, it is predictable that subrogation might be considered as a possible predicate for an insurer's reimbursement claim. Upon closer scrutiny, however, it is apparent that the doctrine cannot be used to support the insurer's reimbursement claim. "Subrogation is an equitable right that enables one who is secondarily liable for a debt and who pays it to succeed to the rights, if any, that the creditors hold against the debtor." JERRY, *supra* note 1, § 96[a], at 600. Thus, in its most common insurance application, if the insurer pays the insured's loss, the insurer is entitled to assert the insured's rights against third parties that caused the insured's loss. The insured's incurring defense costs is not a loss for which a third party is responsible, and by paying the defense costs, the insurer does not pay a third party's debt owed the insured (e.g., the tortfeasor's debt to the insured). In seeking reimbursement, the insurer asserts a claim against its own insured, which does not and cannot happen under the doctrine of equitable subrogation. See *id.* § 96[f], at 612–13 (noting that subrogation by insurer against own insured not allowed).

50. Even this starting point is controversial. Professor Andrew Kull forcefully argues that restitution should be viewed as a substantive theory (with accompanying remedy), and not a remedy that can be appended to contract claims or tort claims. See Andrew Kull, *Rationalizing Restitution*, 83 CAL. L. REV. 1191, 1204–10 (1995) [hereinafter Kull, *Rationalizing*]. See generally Andrew Kull, *Restitution as a Remedy for Breach of Contract*, 67 S. CAL. L. REV. 1465 (1994) [hereinafter Kull, *Remedy for Breach*]. That restitution is an independent substantive theory of recovery is beyond dispute, even if the substantive theory is too often overlooked and under-emphasized. As long as the term "restitution" is used to describe a remedy in the context of a contractual transaction, see RESTATEMENT (SECOND) OF CONTRACTS §§ 370–377 (1981), restitution will continue to be understood as having a remedial dimension that operates in conjunction with other substantive theories of recovery.

51. "Corrective justice" refers to the kind of justice that "captures the correlativity within a single transaction, of wrongful doing and suffering—and with it the correlativity in private law of the defendant's duty to avoid inflicting such suffering and the plaintiff's right to immunity from it." Ernest J. Weinrib, *Legal Formalism: On the Immanent Rationality of Law*, 97 YALE L.J. 949, 978 (1988).

distributive justice.<sup>52</sup> Fundamental notions of corrective justice suggest that a party upon whom excess benefits are nongratuitously bestowed ought, in fairness, to return them to the conferring party.<sup>53</sup> This principle has many beneficial applications in our society. It helps explain, for example, why a thief must return goods taken from a victim,<sup>54</sup> why one party to an unenforceable contract must

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52. See Weinrib, *supra* note 51, at 988–92 (explaining that distributive justice occurs in distributions, whereas corrective justice occurs in transactions). “In distributive justice, things are allocated to persons in accordance with a criterion of distribution. The criterion will be chosen in the light of, and will be applied to promote, the purpose that a given distribution is intended to realize.” Peter Benson, *The Basis of Corrective Justice and Its Relation to Distributive Justice*, 77 IOWA L. REV. 515, 535 (1992). “In corrective justice the holdings of the parties immediately prior to their interaction ‘provides the baseline from which the gain and the loss’ are calculated. In distributive justice, the baseline is set by a completely separate criterion, generally based on some notion of worth.” Jeffrey O’Connell & Christopher J. Robinette, “Choice Auto Insurance”: *Do Theories of Justice Require Linkage Between Injurers and the Injured?*, 1997 U. ILL. L. REV. 1109, 1128 (footnote omitted).

53. “[C]orrective or compensatory justice is concerned with the category of wrongful gains and losses. Rectification...is a matter of justice when it is necessary to protect a distribution of holdings (or entitlements) from distortions which arise from unjust enrichments and wrongful losses. The principle of corrective justice requires the annulments of both wrongful gains and losses.” JULES L. COLEMAN, *MARKETS, MORALS, AND THE LAW* 185 (1988). “Restitution concerns itself primarily with wrongful gains.” Jules L. Coleman, *The Mixed Conception of Corrective Justice*, 77 IOWA L. REV. 427, 444 (1992).

54. See 1 DAN B. DOBBS, *DOBBS LAW OF REMEDIES* 554 (2d ed. 1993) (discussing remedy for victim of theft of watch); I GEORGE E. PALMER, *THE LAW OF RESTITUTION* § 1.1, at 3 (1978) (explaining restitutionary remedy for benefit received by thief). Of course, other theories could be used to explain the remedy the victim’s loss, including an action for damages in tort. A recent draft of a proposed *Restatement (Third) of Restitution* would place the restoration remedy for theft outside the scope of this body of law. For more information on the proposed *Restatement (Third) of Restitution*, see *infra* note 72. “Liability in restitution is imposed in response to a transfer that lacks an adequate legal basis,” and such transfers fall within three broad categories: transfers void or voidable at the election of the transferor; transfers where the plaintiff intentionally confers a benefit on the defendant not intending to make a gift; and transactions in which a benefit is obtained by wrongdoing. RESTATEMENT (THIRD) OF RESTITUTION § 1 cmt. d (Council Draft No. 1, 1999). Through explicit articulation of what is “unjustified enrichment” calling for liability in restitution, the structure of the proposed *Restatement (Third) of Restitution* excludes “many other legal relations in which an owner’s entitlement to the restoration of property might theoretically be explained in terms of the defendant’s unjust enrichment but which, by convention, are not so classified.” *Id.* § 1 cmt. c. Because the unjust enrichment accompanying a theft can be remedied under tort law, the proposed *Restatement (Third) of Restitution* does not include such a claim under the law of restitution. “It would serve no useful purpose to elaborate a redundant, enrichment-based explanation of the owner’s right to recovery of property from a thief, or of a contracting party’s right to recover a prepayment upon the other party’s repudiation, simply because the legal relations in question already receive a full account in tort or contract, as the case may be.” *Id.* The intention of this structuring of the law of restitution is to give it not only precision but also an identity separate from other substantive bodies of law, such as tort and contract.

return the benefits of the receipt of the other side's part performance to the other,<sup>55</sup> and why a party who has received a benefit by virtue of the conferring party's mistake ought to return it.<sup>56</sup> Traditionally, the justification for these solutions lies in the recognition that one party has received an "enrichment" that, if retained, would result in an injustice, i.e., "unjust enrichment."<sup>57</sup> Restitution also promotes distributive justice, although less aggressively than corrective justice. In some contexts, restitution creates wealth-maximizing exchanges in circumstances where

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"[R]estitution (meaning the law of unjust or unjustified enrichment) is itself a source of obligations, analogous in this respect to tort or contract." *Id.* § 1 cmt. h.

55. See, e.g., *Reynolds v. Slaughter*, 541 F.2d 254, 256 (10th Cir. 1976) (allowing plaintiff restitution for loss suffered upon defendant's nonperformance of an oral contract deemed unenforceable under the statute of frauds); *Montanaro Bros. Builders, Inc. v. Snow*, 460 A.2d 1297, 1301 (Conn. 1983) (stating that vendor on land sale contract must return payments received where contract is unenforceable under statute of frauds).

56. See, e.g., *Bridges v. Cal-Pacific Leasing Co.*, 93 Cal. Rptr. 796, 798 (Ct. App. 1971) (concluding that payor for leased restaurant equipment is entitled to restitution for payments made to one mistakenly believed to own the equipment); *Sunwest Bank of Albuquerque, N.A. v. Colucci*, 872 P.2d 346, 349-50 (N.M. 1994) (stating that bank is entitled to recover sum mistakenly paid to beneficiary whose interest was payable only upon death of both joint tenants).

57. See *Atlantic Coastline R.R. v. Florida*, 295 U.S. 301, 309 (1935) (stating that the test for recovery in restitution is whether a benefit "was received in such circumstances that the possessor will give offense to equity and good conscience if permitted to retain it"). The restitution framework championed by Professor Kull puts all enrichments related to contractual transactions outside the scope of restitution. He contends that restitution is, in fact, based on the principle of unjust enrichment, and urges that restitution has no relevance to legal disputes arising out of enforceable contracts. See Kull, *Rationalizing*, *supra* note 50, at 1196-97. This framework is the scheme of the proposed *Restatement (Third) of Restitution*, for which Professor Kull is the reporter. See sources cited *supra* note 54 and accompanying text. The anchor of contract remedies is, of course, protecting expectation, see *RESTATEMENT (SECOND) OF CONTRACTS* § 347 (1981), but contract law contemplates that aggrieved plaintiffs are, subject to the usual limiting rules (such as certainty and foreseeability) allowed to opt down to the lesser remedies of reliance or restitution if they choose. Thus, in contract law, restitution may be an appropriate remedy for breach of contract or failure of contract, but in noncontractual settings, restitution is an independent, substantive theory upon which one person's liability to another is predicated. See 1 DOBBS, *supra* note 54, at 552 ("Restitution is often an appropriate remedy for breach of an enforceable contract, whether or not there is a 'rescission' of that contract."); I PALMER, *supra* note 54, § 4.1, at 366 ("[T]he central fact is that, in the circumstances discussed in this chapter, restitution, when available, is a remedy for the defendant's breach of contract."). For a critique of such a postulation of restitution, see Kull, *Rationalizing*, *supra* note 50, at 1222-26 (arguing that describing restitution as a "remedial alternative" is undesirable; "a unitary definition of restitution is preferable to a complex one"), and see generally Kull, *Remedy for Breach*, *supra* note 50. If Professor Kull's analytical framework defines the boundaries of the substantive law of restitution, it undercuts the insurer's argument for reimbursement of defense costs, given that the insurer makes its claim in the context of an enforceable contract. See Quinn, *supra* note 11, at 605.

prohibitive transaction costs preclude bargaining.<sup>58</sup> This illuminates restitution's situs relative to the boundary of contract law; the principles of the law of restitution deny recovery to those who officiously confer benefits in circumstances where it was feasible to go to the market and negotiate an exchange with the beneficiaries of their gratuity.<sup>59</sup> Thus, it might be said that when bargains are feasible, restitution defers to contract law's scheme of distributive justice. This suggests that distributive justice is not the goal which restitution most consistently or fervently serves<sup>60</sup> and that corrective justice is restitution's most salient feature.

In each of the examples noted above—theft, unenforceable contract; and mistake—as well as most others that might be identified, the enrichment is received as a direct consequence of a loss by some other party. The persistent pairing of benefit with loss or invasion of an interest suggests, as Professor Laycock has explained,<sup>61</sup> that restitution has a restorative function that

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58. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 133–34 (4th ed. 1992); Saul Levmore, *Explaining Restitution*, 71 VA. L. REV. 65, 67 (1985) (“[R]estitution...present[s] the question of whether to create bargains where the parties have not done so.”). But see 1 DOBBS, *supra* note 54, at 558 (“[U]njust enrichment refers to corrective justice, not distributive justice. It does not invite judgments about the fair distribution of wealth in society.”).

59. See Charles Silver, *A Restitutionary Theory of Attorneys' Fees in Class Actions*, 76 CORNELL L. REV. 656, 667 (1991) (“Restitution thus frowns on providers who attempt to substitute courts for markets.”). See also RESTATEMENT (THIRD) OF RESTITUTION § 2 cmt. a (Council Draft No. 1, 1999).

[T]he characteristic feature of those transactions that give rise to a liability in restitution...is that a benefit has been conferred...outside the consensual framework that would ordinarily govern the transaction in question. Broadly speaking, it is the absence of a bargain between the parties that explains why such a benefit constitutes unjustified enrichment in the hands of the recipient.

*Id.*

Even granting that the boundary between restitution and contract deserves explicit demarcation, it does not follow that restitution has no relevance to every relationship between parties grounded in contract, and Professor Kull's framework should not be so understood. If a party over-performs a contract by mistake and thereby confers a benefit on the other party, the remedy for the unjust enrichment lies in restitution rather than contract. Professor Palmer grouped the over-performance cases together under the heading of “mistake in performance.” See III PALMER, *supra* note 54, §§ 14.1–28. Restitution for mistaken over-performance of a contract duty also receives implicit approval in the proposed *Restatement (Third) of Restitution*. See RESTATEMENT (THIRD) OF RESTITUTION § 1 illus. 6 (Council Draft No. 1, 1999) (describing the following: A overpays a debt owed B; no contract between A and B establishes a duty to refund the over-payment; B's “obligation to refund the overpayment is a liability in restitution”; assume A's prior debt is created by contract). The problem of mistaken over-performance is given further attention below. See *infra* text accompanying note 161.

60. See Silver, *supra* note 59, at 668.

61. See Douglas Laycock, *The Scope and Significance of Restitution*, 67 TEX. L. REV. 1277, 1279 (1989). But see Kull, *Rationalizing*, *supra* note 50, at 1194, 1215–19 (discussing and critiquing Laycock's position).

accompanies the function of preventing the retention of an undeserved gain. This conceptualization of restitution gives it a dual focus, with neither dimension subsuming the other. Preventing unjust enrichment emphasizes the defendant's gain, while restoration focuses on the plaintiff's loss.<sup>62</sup> In contrast to the dual-dimension construction is a framework urged by Professor Wonnell, who argues that "[a] unitary principle of liability based upon unjust enrichment is not coherent or normatively plausible and should be abandoned."<sup>63</sup> He proposes restating the law of restitution in terms of four discrete principles, each of which reinforces the contention that most restitution cases "are ultimately grounded in harm-based rather than benefit-based remedial theories."<sup>64</sup>

The traditional understanding of restitution, however, does not look at the conferring party's loss and instead focuses on the recipient's benefit.<sup>65</sup> An enrichment-oriented doctrine is sufficient to generate just results when one party is benefitted through theft or the mistaken conferral of a benefit.<sup>66</sup> The same benefit-oriented reasoning operates when restitution is awarded to an aggrieved party as the remedy for breach of contract,<sup>67</sup> and the logic is apparent in those cases in noncontractual settings where plaintiffs seeking restitution have been awarded more than they lost.<sup>68</sup> The traditional understanding also resonates in the *Restatement of Restitution* promulgated by the American Law Institute in 1937,<sup>69</sup>

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62. This distinction, Professor Laycock argues, explains the more powerful remedies awarded to plaintiffs who can trace specific property that has found its way into a defendant's hands. See Laycock, *supra* note 61, at 1280. For a rejoinder, see Kull, *Rationalizing*, *supra* note 50, at 1216-19.

63. Christopher T. Wonnell, *Replacing the Unitary Principle of Unjust Enrichment*, 45 EMORY L.J. 153, 219 (1996).

64. *Id.* at 155.

65. See 1 DOBBS, *supra* note 54, at 552 (stating that restitution's "purpose is to prevent the defendant's unjust enrichment by recapturing the gains the defendant secured in a transaction"); DOUGLAS G. LAYCOCK, MODERN AMERICAN REMEDIES 524 (2d ed. 1994) ("The most distinctive feature of restitution is that liability is based on, and recovery is usually limited by, benefit to defendant rather than harm to plaintiff."); Kull, *Rationalizing*, *supra* note 50, at 1193 (1995) ("The modern consensus puts unjust enrichment at the heart of liability in restitution...."). Comment b of section 1 to the proposed *Restatement (Third) of Restitution* quotes *Moses v. Macferlan*, 2 Burr. 1005, 97 Eng. Rep. 676, 681 (1761), where Lord Mansfield stated: "In one word, the gist of this kind of action [referring to quasi-contract] is, that the defendant, upon the circumstances of the case, is obliged by the ties of natural justice and equity to refund the money." RESTATEMENT (THIRD) OF RESTITUTION § 1 cmt. b (Council Draft No. 1, 1999)

66. See *supra* notes 54, 56.

67. See RESTATEMENT (SECOND) OF CONTRACTS § 370 (1981) ("A party is entitled to restitution under the rules stated in this Restatement only to the extent that he has conferred a benefit on the other party by way of part performance or reliance.").

68. See, e.g., *Edward's v. Lee's Admin.*, 96 S.W.2d 1028 (Ky. 1936); *Olwell v. Nye & Nissen Co.*, 173 P.2d 652 (Wash. 1946).

69. RESTATEMENT OF RESTITUTION § 1 (1937). Comment a to section 1 states: "A person is enriched if he has received a benefit.... A person is unjustly enriched if the retention of the benefit would be unjust.... A person obtains restitution when he is restored to the position he formerly occupied either by the returning of something which he formerly

in the first section of the Tentative Draft of the ill-fated *Restatement (Second) of Restitution*,<sup>70</sup> in the text of Professor Palmer's preeminent treatise,<sup>71</sup> and in the first section of the November 1999 Council Draft of the proposed *Restatement (Third) of Restitution*.<sup>72</sup>

Yet, even under the traditional understanding of restitution that focuses on retrieving benefits conferred and relieving unjust enrichments, the relationship between benefit and loss in the law of restitution is hardly tidy. To illustrate this murkiness, consider the foundational first section in the 1937 *Restatement of Restitution*: "A person who has been unjustly enriched at the expense of another must make restitution to the other."<sup>73</sup> If one emphasizes the term "expense" in the phrase "at the expense of another" and construes it as the equivalent of net economic detriment, one might conceptualize restitution as a harm-repairing remedy that measures the relief to be awarded by reference to the value of the benefit conferred.

If, however, the phrase "at the expense of another" is read as a whole, it could be understood to refer to whatever serves to link the defendant's enrichment

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had or by the receipt of its equivalent in money." Comment b makes clear that the notion of "benefit" is meant to be broad—encompassing the performance of service for another, adding to the property of another, and saving another from expense or loss, i.e., "any form of advantage." *Id.* § 1 cmt. b.

70. RESTATEMENT (SECOND) OF RESTITUTION § 1 (Tentative Draft No. 1, 1983) (stating that restitution is predicated on the receipt of "a benefit by reason of an infringement of another person's interest, or of loss suffered by the other"). Efforts to draft a *Restatement (Second) of Restitution* were abandoned in the mid-1980s, even though two tentative drafts received the membership's approval at annual meetings. See AMERICAN LAW INSTITUTE, 1983 ANNUAL REPORT 178 (1983); AMERICAN LAW INSTITUTE, 1984 ANNUAL REPORT 403 (1984). To my knowledge, no official explanation for the abandonment of the project was ever offered, although a reader of the 1984 proceedings might surmise that the discussion on the floor of the Institute did not go as well as the project's supporters hoped, which might have led to a consensus to allow the project to succumb with little fanfare.

71. See I PALMER, *supra* note 54, § 2.10, at 133 ("Restitution is generally awarded only in order to deprive the defendant of an enrichment obtained at the plaintiff's expense.... The general requirement does not mean that the gain to the defendant need to be equated to the loss to the plaintiff, nor indeed that there need be any loss to the plaintiff except in the sense that a legally protected interest has been invaded.").

72. RESTATEMENT (THIRD) OF RESTITUTION § 1 (Council Draft No. 1, 1999) ("A person who is unjustly enriched at the expense of another is liable in restitution to the other."). In 1997, the American Law Institute announced its intention to draft a *Restatement (Third) of Restitution*. Efforts in the 1980s to draft a *Restatement (Second) of Restitution* were abandoned. See *supra* note 70. Consideration had been given to incorporating the subject of restitution into a new *Restatement of Remedies*, but the ALI Council decided to embark upon a self-contained product. The reporter for the project is Professor Andrew Kull.

73. RESTATEMENT OF RESTITUTION § 1 (1937). Note that this formulation is substantially identical to the foundational first section in the Council Draft of the *Restatement (Third) of Restitution*. See *supra* note 72.

to an aggrieved party, thereby identifying a particular aggrieved party as the one to whom an enrichment, if it cannot justifiably be retained by the defendant, ought to be returned.<sup>74</sup> Under this construction, the "at the expense of another" phrase serves primarily to identify the appropriate plaintiff, i.e., the one who deserves to receive the sum that the enriched party must disgorge. This conceptualization emphasizes a beneficiary's enrichment and largely disregards the conferring party's detriment; under this formulation, the "expense" can be the "invasion of an interest" belonging to the conferring party, unaccompanied by any kind of net economic detriment.<sup>75</sup>

In short, there is much uncertainty about and disagreement over the contours of the law of restitution.<sup>76</sup> In such circumstances, the likelihood is low that restitution will provide an incontestable explanation of why insurers are, or are not, entitled to reimbursement of defense costs incurred in defending noncovered claims. Although case law discussion of this issue is sparse, divergent judicial views about the import of restitution in this context are already evident, as the next subsection explains.

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74. In the comments to the Council Draft of the *Restatement (Third) of Restitution*, the Reporter uses the term "unjustified enrichment" to draw sharp distinctions between some forms of unjust enrichment which the law of restitution will not remedy and the more narrow, predictable, and objectively determinable circumstances in which an adequate legal basis for a restitution remedy exists. See *RESTATEMENT (THIRD) OF RESTITUTION* § 1 cmt. b (Council Draft No. 1, 1999).

75. This broader reading is part of the structure of the proposed *Restatement (Third) of Restitution*. For example, illustration 5 to section 1 involves A repeatedly and intentionally trespassing on B's land to avoid the higher costs of an alternative route and to avoid paying B for a license. What A saves is deemed an unjustified enrichment for which A is liable, "whether or not A's repeated trespass has caused any injury to B's land." *Id.* § 1 illus. 5. This is an example of an unjust enrichment that involves no net economic detriment but which is conferred at the expense of another. *Id.*

76. See 1 DOBBS, *supra* note 54, at 551 ("Most generalizations about restitution are trustworthy only so long as they are not very meaningful, and meaningful only so long as they are not very trustworthy."); 1 PALMER, *supra* note 54, Preface ("Restitution has no well-defined boundaries because it is concerned with unjust enrichment."); Kull, *Rationalizing*, *supra* note 50, at 1194 (observing that the disagreement in restitution over core principles "would be unthinkable" in the law of torts or contracts); *id.* at 1195 ("Confusion over the content of restitution carries significant adverse consequences."); Philip Mechem, *A Realistic Treatment of Restitution*, 25 IOWA L. REV. 187, 190 (1939) (noting that the subject of restitution "is a truly superlative collection of jurisprudential loose ends"); Stewart Macaulay, Comment, *Restitution in Context*, 107 U. PA. L. REV. 1133, 1135 (1959) (stating that restitution represents the "relative freedom [of courts] to decide cases unburdened by formal rules"). Comments in the current draft of the proposed *Restatement (Third) of Restitution* acknowledge the critique, even as the substantive content of the draft seeks to dispel it: "Unless a definition of restitution can provide a more informative generalization about the nature of the transactions leading to liability, it is difficult to refute the objection that sees in 'unjust enrichment,' at best, a name for a legal conclusion that remains to be explained; at worst, an open-ended and potentially unprincipled charter of liability." *RESTATEMENT (THIRD) OF RESTITUTION* § 1 cmt. b (Council Draft No. 1, 1999).

*B. Restitution and Reimbursement: Divergent Judicial Views*

One of the first cases to consider the insurer's right to reimbursement for costs incurred in defending noncovered claims was *Terra Nova Insurance Co. v. 900 Bar, Inc.*<sup>77</sup> In *Terra Nova*, a liability insurer sought a declaratory judgment on the question of its duties to defend and indemnify the insured with respect to state court actions brought by the insured's customers, who claimed they had been shot in the insured's tavern by one of the insured's employees. The customers alleged the insured's negligent and intentional infliction of serious bodily harm. The insurer contended that the policy's assault and battery exclusion eliminated coverage and that, as a consequence, the insurer had no duty to defend. The procedural course of the case became complicated,<sup>78</sup> but eventually the court found it necessary to predict whether Pennsylvania law would allow an insurer to obtain reimbursement of costs incurred in defending noncovered claims. On that issue, the court reasoned that it would not, stating:

A rule permitting such recovery would be inconsistent with the legal principles that induce an insurer's offer to defend under reservation of rights. Faced with uncertainty as to its duty to indemnify, an insurer offers a defense under reservation of rights to avoid the risks that an inept or lackadaisical defense of the underlying action may expose it to if it turns out there is a duty to indemnify. At the same time, the insurer wishes to preserve its right to contest the duty to indemnify if the defense is unsuccessful. Thus, such an offer is made at least as much for the insurer's own benefit as for the insured's. If the insurer could recover defense costs, the insured would be required to pay for the insurer's action

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77. 887 F.2d 1213 (3d Cir. 1989).

78. The district court stayed the insurer's declaratory judgment action, and the insurer appealed. The Third Circuit vacated the stay but directed the district court on remand to dismiss the insurer's allegations that it had no duty to defend the insured. *See id.* at 1216. Pennsylvania adheres to the potentiality rule, *see Erie Ins. Exch. v. Transamerica Ins.*, 533 A.2d 1363, 1368 (Pa. 1987) (stating that the duty to defend exists "whenever the complaint filed by the injured party may potentially come within the coverage of the policy" (citing *Gedeon v. State Farm Mut. Auto. Ins. Co.*, 188 A.2d 320 (Pa. 1963))), but this rule was rendered irrelevant when the insurer, in making its case that no coverage existed, "disclaimed any desire to go beyond the pleadings in the state court [i.e., underlying tort] suits." *Terra Nova*, 887 F.2d at 1216. On that record, the district court found itself unable to conclude "that [the insurer] would not have to indemnify [the insured,]" and this necessarily meant, according to the Third Circuit, that the insurer owed a defense to the insured. *Id.* Before mandating this result, however, the Third Circuit vacated the district court's stay; the court justified vacatur, in part, under the reasoning that the stay order, if enforced, would moot the insurer's declaratory judgment action if the insurer were forced to defend the insured and if Pennsylvania law would deny the insurer a reimbursement right in the event the claims were subsequently determined to be outside coverage. *See id.* at 1219-20.



in protecting itself against the estoppel to deny coverage that would be implied if it undertook the defense without reservation.<sup>79</sup>

The court did not use the word "restitution" when discussing the reimbursement right, but the law of restitution provided the framework for the court's analysis. When observing that a defense is provided for the insurer's "own benefit," the court was essentially stating that the insurer suffers no "loss" when providing a defense under reservation. Although the insured receives a benefit in such circumstances, the benefit is not received *at the insurer's expense*. Thus, whatever benefit the insured receives is not "unjust," and no principle of fairness requires the insured to return this benefit to the insurer.<sup>80</sup> Indeed, if the insured were forced to return the value of this benefit to the insurer, such a result would be tantamount to making the insured pay for a benefit—protection for the insurer against the outcome of being estopped to deny coverage—that the insurer decided, acting unilaterally, to obtain for itself.

The reasoning of *Terra Nova* was subsequently followed, either explicitly or implicitly, in a few cases,<sup>81</sup> but other courts analyzed the issue very differently.<sup>82</sup> The most prominent of these cases was the California Supreme

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79. *Terra Nova*, 887 F.2d at 1219–20.

80. Under the framework of the proposed *Restatement (Third) of Restitution* and the reasoning of this case, this benefit—even if an enrichment—would not be an "unjustified enrichment," and would not be a benefit that could not be "conscientiously...retained." *RESTATEMENT (THIRD) OF RESTITUTION* § 1 cmt. b (Council Draft No. 1, 1999).

81. See *Federal Ins. Co. v. Susquehanna Broad. Co.*, 727 F. Supp. 169, 172 n.3 (M.D. Pa. 1989) (stating that "plaintiff [insurer] is not entitled to reimbursement of any of its defense costs incurred" in defending the underlying action, which was terminated by a settlement); *Reliance Ins. Co. v. Alan*, 272 Cal. Rptr. 65, 69–70 (Ct. App. 1990); *Travelers Ins. Co. v. Leshner*, 231 Cal. Rptr. 791 (Ct. App. 1986). In *Omaha Indem. Ins. Co. v. Cardon Oil Co.*, the court found the insurer's explicit reservation of the right to seek reimbursement to be enough to enable it to seek recoupment. See *Omaha Indem. Ins. Co. v. Cardon Oil Co.*, 902 F.2d 40, No. 88-2824, 1990 WL 55904, at \*5 (9th Cir. 1990) (unpublished table decision). In a footnote, the court declined to reach the insurer's restitution and estoppel theories of reimbursement under the reasoning that what it had said about the reservation letter decided the case, but added that it was "doubtful that [the insurer] could prevail on either [theory]," specifically mentioning that the cases discussing restitution went against the insurer's position. *Id.* at \*5 n.1. In *In re Hansel*, the liability insurer's claim for litigation costs expended in defending noncovered claims was rejected on the ground that the reservation letter did not make clear the insurer's intention to seek such costs in the event of a no-coverage determination. See *In re Hansel*, 160 B.R. 66, 70 (Bankr. S.D. Tex. 1993). In dictum, the court noted the absence of any Texas law authorizing reimbursement, and referred to pre-*Buss* California cases holding that the insurer lacks an equitable restitution right to reimbursement of defense costs when the insurer's primary motive is to protect its own interests by defending and not those of the insured. See *id.*

82. See, e.g., *Forum Ins. Co. v. County of Nye*, 26 F.3d 130 (9th Cir. 1994) (unpublished table decision); *Knapp v. Commonwealth Land Title Ins. Co.*, 932 F. Supp. 1169 (D. Minn. 1996); *Resure v. Chemical Distribs., Inc.*, 927 F. Supp. 190 (M.D. La. 1996), *aff'd*, 114 F.3d 1184 (unpublished table decision) (5th Cir. 1997), *cert. denied*, 118

Court's 1997 decision in *Buss v. Superior Court*.<sup>83</sup> In the underlying litigation, plaintiff H&H Sports ("H&H") filed a complaint containing twenty-seven causes of action against Jerry Buss & California Sports, Inc. ("Buss").<sup>84</sup> Buss tendered all of the actions to his insurers for a defense, but each insurer—with the exception of Transamerica Insurance Company ("Transamerica"), which had issued two comprehensive general liability ("CGL") policies to Buss—denied coverage and refused to defend. Transamerica accepted the defense of the H&H actions because one of the twenty-seven causes of action—a defamation claim—was, in Transamerica's judgment, at least potentially covered, even though the other twenty-six causes of action were not. In light of the prevalence of noncovered claims, Transamerica reserved all its rights, including the right to deny coverage and to seek reimbursement of defense costs.<sup>85</sup> Transamerica also agreed to provide independent counsel for Buss.<sup>86</sup>

Buss and H&H settled the underlying litigation for \$8.5 million,<sup>87</sup> and Transamerica paid Buss' independent counsel a sum just over \$1 million. Of this sum, an expert for Transamerica testified that a figure somewhere between two and five percent of the total amount paid the independent counsel was the cost of defending the defamation claim; thus, approximately \$950,000 was expended by Transamerica in defending noncovered claims.<sup>88</sup> Transamerica sought to recover this sum from Buss.<sup>89</sup> Transamerica prevailed in the court of appeals on the reimbursement issue;<sup>90</sup> on Buss' petition, the supreme court granted review.<sup>91</sup>

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S. Ct. 1511 (1998); *Gotham Ins. Co. v. GLNX, Inc.*, 92 Civ. 6415 (TPG), 1993 WL 312243 (S.D.N.Y. Aug. 6, 1993); *Western Employers Ins. Co. v. Arciero & Sons, Inc.*, 194 Cal. Rptr. 688 (Ct. App. 1983) (giving insurer restitution for sums paid in defending suit); *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083 (Colo. 1991) (en banc).

83. 939 P.2d 766 (Cal. 1997). For a more detailed summary of the case, see Richmond, *supra* note 11, at 480–85.

84. In the underlying litigation, H&H alleged that Buss, the owner of various sporting enterprises (such as the Los Angeles Lakers NBA basketball franchise, the Los Angeles Kings NHL hockey franchise, and the Forum indoor sports arena), entered into various contracts with H&H, under which H&H provided Buss with advertising and other services. For a time, Buss performed his contract with H&H, but he subsequently unilaterally terminated the contract. H&H sued, seeking over \$297 million in damages. *See Buss*, 939 P.2d at 769.

85. *See id.* at 770. Transamerica's reservation letter stated that "[w]ith respect to defense costs incurred or to be incurred in the future," Transamerica reserved the right "to be reimbursed and/or [to obtain] an allocation of attorney's fees and expenses in this action if it is determined that there is no coverage...." *Id.* Thereafter, Buss and Transamerica entered into an agreement, supported by consideration, providing that "[i]f a court...orders that defense costs be shared pro rata by...Buss...and Transamerica,...Buss...shall reimburse Transamerica for the appropriate pro rata share of the fees and costs paid to that date." *Id.*

86. *See id.*

87. *See id.*

88. *See id.*

89. The issues arose in this manner: After Transamerica refused to contribute to the settlement, Buss sued Transamerica, complaining about Transamerica's denial of a duty

At the outset, the court explained that under California law the insurer has a duty to defend potentially covered claims as soon as the defense of the underlying claims is tendered and until the underlying litigation is concluded.<sup>92</sup> Accordingly, in an action where all claims are potentially covered, the insurer has a duty to defend; but if no claims are potentially covered, the insurer has no duty to defend.<sup>93</sup> If potentially covered claims and noncovered claims are combined in the same complaint (thereby giving rise to a "mixed action"), the insurer's *contractual* duty to defend extends to the potentially covered claims only.<sup>94</sup> Even

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to defend all claims in H&H's suit and its refusal to contribute to the settlement. In a cross-complaint, Transamerica alleged that Buss denied its right to reimbursement of defense costs incurred in defending everything except the defamation action, and denied its obligation to contribute to the settlement. Transamerica sought summary judgment against Buss on Buss' complaint, which the court granted based on its conclusion that there was no "reasonable basis for Transamerica to join in the settlement" on the defamation cause of action. Buss then moved for summary judgment against Transamerica on its cross-complaint for reimbursement for defense costs, and this motion was denied. Buss then filed a petition for writ of mandate in the court of appeals. *See id.* at 770-71.

90. The court of appeals denied a peremptory writ, finding no error and holding as follows:

[A]n insurer may not seek reimbursement from an insured for defense costs as to claims that are at least potentially covered—in the H & H Sports action, the defamation cause of action against Buss; it may, however, seek reimbursement for costs as to those that are not—in that action, all the others; it may obtain reimbursement for the costs that can be allocated solely to these claims; to do so, it must carry the burden of proof; the burden it must carry is proof by a preponderance of the evidence....

*Id.* at 771-72.

91. *See id.* at 772.

92. The court contrasted the duty to defend with the duty to indemnify. The latter "runs to claims that are actually covered, in light of the facts proved.... It arises only after liability is established." *Id.* at 773 (citations omitted). The duty to defend, in contrast, runs to claims that are merely potentially covered, in light of facts alleged or otherwise disclosed. It arises as soon as tender is made. It is discharged when the action is concluded.... It may be extinguished earlier, if it is shown that no claim can in fact be covered. If it is so extinguished, however, it is extinguished only prospectively and not retroactively: before, the insurer had a duty to defend; after, it does not have a duty to defend further.

*Id.* (citations omitted).

Thus, "the insurer's duty to defend is broader than its duty to indemnify. But, just as obviously, it is not unlimited. It extends beyond claims that are actually covered to those that are merely potentially so—but no further." *Id.* (footnote and citations omitted).

93. The court explained that the "freedom" not to defend noncovered claims "is implied in the policy's language. It rests on the fact that the insurer has not been paid premiums by the insured for a defense." *Id.* at 774.

94. *See id.* The rationale for this conclusion was grounded in the fact that the insured pays a premium for the defense of covered claims, and pays nothing for a defense of noncovered claims. *See id.* Justice Kennard disagreed with this conclusion, reasoning

so, as the court explained, the insurer has a duty *implied by law* to defend the mixed action in its entirety.<sup>95</sup> Thus, when the insurer performs the noncontractual implied duty and defends a mixed action in its entirety, the insured may receive extra-contractual benefits from the insurer.<sup>96</sup> In conceptualizing the insurer's duty

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that the insurer's duty to defend noncovered claims was contractually based, rather than implied-in-law, in that the text of the policy requires the insurer to defend "suits, rather than individual claims." *Id.* at 785 (Kennard, J., dissenting). The insurer's interest in defending noncovered claims comes from the insurer's desire to control the defense of all claims; in other words, in exchange for the insured giving up the right to control the defense of noncovered claims, which enables the insurer to better control the defense of covered claims, the insurer agrees to pay for the defense of the entire suit. *See id.* As a matter of textual interpretation, "suit" and "claim" presumably have different meanings, or the drafters would have used only one of the words. Note that later in the "Insuring Agreement," "suit or claim" appears in the disjunctive, whereas in the "right and duty" sentence of the insuring agreement, only the word "suit" appears. Arguably, then, the meaning of the "duty to defend" language is that the insurer has the duty to defend the entire suit, i.e., a duty to defend any suit in which at least one covered claim is made against the insured. Note that policies in other lines of insurance (such as homeowners and automobile) refer to both claims and suits, suggesting that the CGL was drafted differently for a reason. Thus, the dissent's textual argument in *Buss* is quite strong. Insurers typically find themselves on the side of textual literalism; in this setting, literalism does not serve insurers' interests well.

Notwithstanding the strength of the dissent's argument, it is doubtful that the drafters intended the meaning given to the CGL by the dissent. Because, under this interpretation, the insurer would have a duty to pay for the defense of all noncovered claims as long as at least one covered claim was asserted, plaintiffs' counsel would have a powerful incentive to insert at least one covered claim in every complaint—which is tantamount to moral hazard run rampant. The drafters surely did not intend the defense obligation to reach so far, and it is doubtful that policyholders desire such broad coverage. *See supra* text accompanying notes 42–43; *infra* text accompanying notes 230–233. Courts have confronted a similar issue in the situation where the insured sues the insurer for reimbursement of defense costs after the insurer has breached the duty to defend; in this context, there is authority for the proposition that the insurer's reimbursement obligation is limited to covered claims, and that no reimbursement obligation exists for noncovered claims, i.e., claims that are not even potentially within the coverage. *See, e.g., Morgan, Lewis & Bockius v. Hanover Ins. Co.*, 929 F. Supp. 764 (D.N.J. 1996).

95. *See Buss*, 939 P.2d at 775.

[W]e can, and do, justify the insurer's duty to defend the entire 'mixed' action prophylactically, as an obligation imposed by law in support of the policy. To defend meaningfully, the insurer must defend immediately. To defend immediately, it must defend entirely. It cannot parse the claims, dividing those that are at least potentially covered from those that are not. To do so would be time consuming. It might also be futile: The 'plasticity of modern pleading' allows the transformation of claims that are at least potentially covered into claims that are not, and vice versa.

*Id.* (footnote and citations omitted).

96. *See id.*

As to the claims that are at least potentially covered, the insurer gives, and the insured gets, just what they bargained for, namely, the mounting

to defend mixed actions as an extracontractual, implied-in-law duty, the court laid the groundwork for the restitution analysis that would follow.

In that next discussion, the court considered whether "[i]n a 'mixed' action...the insurer [may] seek reimbursement from the insured for defense costs."<sup>97</sup> The court's answer was "no" with respect to potentially covered claims,<sup>98</sup> but "yes" with respect to noncovered claims.<sup>99</sup> In explaining why the insurer has no right to reimbursement for potentially covered claims, the court initially observed that the insurance contract does not implicitly create a right to reimbursement, given that the insurer agreed to bear the costs of defense.<sup>100</sup> Moreover, no right to reimbursement can be implied in law; because the insurer bargained to bear defense costs, any resulting enrichment of the insured is "just," and, therefore, no right to restitution exists.<sup>101</sup> But with respect to claims that are not even potentially covered, the insurer did not bargain to bear the costs of defense, and the insurer's attempt to recoup these costs does not "upset the arrangement" in the liability insurance contract.<sup>102</sup> The insurer's right is "implied in law as quasi-contractual"; that is, the insurer can recoup its costs, the expenditure of which unjustly enriches the insured, under the law of restitution.<sup>103</sup>

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and funding of a defense. But as to the claims that are not, the insurer may give, and the insured may get, more than they agreed, depending on whether defense of these claims necessitates any additional costs.

*Id.*

97. *Id.* at 775.

98. *See id.* The court explained that the answer would change to "yes" if the policy itself provides for reimbursement. Also, the answer would change to "yes" if the insured and insurer subsequently agree in a separate contract superseding the policy that the insurer is entitled to reimbursement. *See id.* at 776.

99. *See id.*

100. *See id.* at 775. Also, under this analysis, an attempted reservation of right to seek reimbursement on potentially covered claims is ineffective, given that there is no right to be reserved. Stated otherwise, a unilateral reservation of a "right" not given in the policy cannot supersede the policy, i.e., cannot create the nonexistent right. *See id.* at 776.

101. *See id.*

102. *Id.* In other parts of the opinion, the court placed the burden on the insurer to establish that the defense costs for which reimbursement is sought are solely allocable to claims for which there was no potential for coverage. *See id.* at 778-83. As the court acknowledged, establishing that the costs can be so segregated will not be easy in most situations. *See id.* at 780-81. For this reason, some commentators have observed that *Buss* is, in reality, a limited victory for insurers. *See Menter, supra* note 11, at 3 (observing the insurer's ability to obtain reimbursement is "[l]imited and [r]isky"); Richmond, *supra* note 11, at 508 (discussing burdens on insurers and the limitation of the rule of the case to mixed actions).

103. *See Buss*, 939 P.2d at 777. This assumes, of course, that the insurer takes appropriate steps to reserve its right to reimbursement. In a footnote, the court explained what the insurer must do to perfect the reservation. *See id.* at 784 n.27. For more discussion of the mechanics of reserving a right to reimbursement, see Richmond, *supra* note 11, at 505-07.

The "enrichment" of the insured by the insurer through the insurer's bearing of unbargained-for defense costs is inconsistent with the insurer's freedom under the policy and therefore must be deemed "unjust." It is like the case of A and B. A has a contractual duty to pay B \$50. He has only a \$100 bill. He may be held to have a prophylactic duty to tender the note. But he surely has a right, implied in law if not in fact, to get back \$50.<sup>104</sup>

At the end of its analysis, the court asserted that recognizing the right of reimbursement makes "good sense" as well: the availability of the right reduces the temptation the insurer might otherwise have to deny the insured a defense in mixed actions where noncovered claims predominate, given that the insurer escapes the possibility of not recouping any of its expenses for defending noncovered claims if the insurer does not defend at all.<sup>105</sup>

Subsequent California cases, as one would expect, have consistently followed *Buss*,<sup>106</sup> and the relatively few courts outside California to subsequently consider the issue have reached conclusions generally consistent with *Buss*.<sup>107</sup> The analysis of *Terra Nova* remains viable, however, and there is a possibility that the Texas Supreme Court soon will consider whether the insurer has a reimbursement right under the law of restitution.<sup>108</sup> Continued variance in judicial assessment of the restitution-based rationale for the insurer's reimbursement right should not be surprising given that the law of restitution is, at best, equivocal on the question. This is discussed in more detail in the next section.

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104. *Buss*, 939 P.2d at 777.

105. *See id.* at 778.

106. *See, e.g., Aerojet-General Corp. v. Transport Indem. Co.*, 948 P.2d 909 (Cal. 1997); *American Motorists Ins. Co. v. Superior Court*, 80 Cal. Rptr. 2d 621, 627 (Ct. App. 1998); *New Hampshire Ins. Co. v. Ridout Roofing Co.*, 80 Cal. Rptr. 2d 286, 291 (Ct. App. 1998); *State v. Pacific Indem. Co.*, 75 Cal. Rptr. 2d 69, 75-77 (Ct. App. 1998).

107. *See, e.g., Liberty Mut. Ins. Co. v. FAG Bearings Corp.*, 153 F.3d 919 (8th Cir. 1998); *Grinnell Mut. Reinsurance Co. v. Shierk*, 996 F. Supp. 836, 839 (S.D. Ill. 1998); cases cited *supra* note 82. In *Liberty Mutual*, the court denied the insurer's request for reimbursement, but presumably because the sole allegation in the complaint was potentially covered, and was therefore analogous to the potentially covered defamation claim in *Buss* for which the insurer had a duty to defend. *See Liberty Mutual*, 153 F.3d at 924.

108. In *Matagorda County v. Texas Ass'n of Counties County Gov't Risk Management Pool*, 975 S.W.2d 782 (Tex. Ct. App. 1998), *review granted* (June 24, 1999), the court considered the issue of an insurer's right to reimbursement, but decided the case on a more limited ground. *See id.* at 786. The court, which, curiously enough, cited both *Buss* and *Terra Nova* with approval, held that the insurer was not entitled to reimbursement of defense costs because the reservation of rights letter did not contain any suggestion that the insurer would attempt to recover defense costs. *See id.* at 785. A reasonable inference from the court's discussion of cases in other jurisdictions is that the insurer might have been entitled to reimbursement if it had clearly and unambiguously reserved its right to seek reimbursement, but this is not clear from the opinion. *See id.* at 784-85.

### *C. Restitution as a Justification for Defense Cost Reimbursement*

When coverage is in doubt for some or all of the claims alleged against the insured, the insurer has essentially three options: defend without qualification or reservation; defend under reservation; or refuse to defend.<sup>109</sup> The first alternative is ill-advised because the insurer who does so is universally deemed to have waived all coverage defenses.<sup>110</sup> Unless the insurer is certain that coverage does not exist, the third alternative is extremely perilous. If a court subsequently determines that the complaint alleged a covered claim (in eight-corners jurisdictions) or that there was a mere potentiality of coverage (in jurisdictions following the potentiality rule), the insurer's declination constitutes a breach of the duty to defend, with all of the consequences that flow from the breach.<sup>111</sup> Thus, insurers typically opt in such situations to defend the insured under a reservation of rights. An insurer's proposed arrangement with its insured to defend under reservation has three basic elements:

1. We (the insurer) are not certain whether one or more of the plaintiff's claims against you (the insured) are covered by your policy with us. They might be covered, or they might not.

2. Because of our uncertainty (that is, because there is a possibility that the claims might subsequently be found to be covered), we are going to provide you with a defense to these claims. In other words, we are going to provide a defense in accordance with the standards that our contract would require if the claim were indisputably within coverage.

3. Even though we will defend you, we reserve the right to argue that one or more of the claims are outside the policy's coverage. If we choose to argue this position later and if we prevail, we will not be obligated to pay whatever judgment, if any, was entered against you in the plaintiff's action.

If the insurer is interested in recouping defense costs, a fourth element will be added to the preceding three:

4. Should it be determined at a later time that the claims are not covered, we will seek from you reimbursement of the costs we expended in defending the noncovered claims.

The insurer's ability to reserve the right to contest coverage (item 3 above) has never been seriously doubted.<sup>112</sup> Indeed, some courts have instructed

109. See Richmond, *supra* note 11, at 467.

110. See OSTRAGER & NEWMAN, *supra* note 33, § 2.02, at 45 (citing representative cases).

111. See generally JERRY, *supra* note 1, § 111[h], at 752-60; 1 WINDT, *supra* note 25, §§ 4.33-38, at 256-71.

112. The consequences of the reservation on the responsibilities of defense counsel has, however, received much attention and in some jurisdictions has been controversial. See 1 WINDT, *supra* note 25, § 4.20, at 219-25. But even in jurisdictions that

insurers to proceed in precisely this manner when they are uncertain about the existence of coverage.<sup>113</sup> Thus, one might wonder why reserving the right to seek reimbursement of defense costs (item 4 above) is controversial at all. In either circumstance—reserving a right to contest coverage or reserving a right to seek reimbursement of defense costs—the insurer takes the position that it has no obligation to spend resources absent a contractual requirement that it do so. Yet the reservations, though similar in form, are substantively quite different. When the insurer reserves the right to contest coverage, the insurer is stating an intention with respect to a separate duty in the liability insurance contract; the insurer says, “we will defend you, but if we lose this lawsuit, we may contest our separate duty to indemnify you by subsequently taking the position that the plaintiff’s claims are outside the coverage of your policy.” If the duty to indemnify is contested, this will occur before the insurer performs it.<sup>114</sup> With respect to the reservation to seek reimbursement of defense costs, the insurer is reserving a right with respect to the duty being undertaken. That is, the insurer says, “we will defend you, but we reserve the right to later argue that we were not obligated to do so because the plaintiff’s claims are outside the policy’s coverage (or are not potentially covered by the policy); and if we are successful, we will seek reimbursement for the costs we incurred in providing you with this defense.” In this respect, then, the defense cost reservation creates the possibility that the insurer will ask for a return of what it presently gives. Nothing of permanence is promised; the insurer says, in effect, “we will pay for this today, but tomorrow we may insist that you pay for it—by paying to us the amounts that we will pay on your behalf today.” The right to contest coverage, by itself, only states that a disputed issue involving the insurer’s indemnity obligation is being postponed until later.<sup>115</sup> Though hardly inconsequential to an insured, putting off resolution of the indemnity obligation until later has relatively little immediate impact on the insured; the postponed issue

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have concluded that the reservation has adverse consequences for the insurer’s right to control the defense, the insurer’s ability to reserve the right to contest coverage has not been doubted.

113. See, e.g., *Flannery v. Allstate Ins. Co.*, 49 F. Supp. 2d 1223, 1228 (D. Colo. 1999) (stating that the “appropriate course of action for an insurer who believes that it is under no obligation to defend, is to provide a defense to the insured under a reservation of its rights to seek reimbursement should the facts at trial prove that” coverage does not exist, or “to file a declaratory judgment action after the underlying case has been adjudicated”); *Sims v. Illinois Nat’l Cas. Co.*, 193 N.E.2d 123, 130 (Ill. App. Ct. 1963); *Patrons Mut. Ins. Ass’n v. Harmon*, 732 P.2d 741, 745 (Kan. 1987).

114. One exception to this ordering involves the situation where the insurer settles the plaintiff’s underlying tort action in circumstances where coverage is doubtful, and the insurer pays the claimant while reserving a right to seek reimbursement of the settlement from the insured in the event the claim is found to be outside coverage. In this situation, courts have generally held that the insurer may make such a reservation. For more discussion, see *infra* note 220.

115. See 1 WINDT, *supra* note 25, § 4.26, at 236. “By reserving its rights [to contest coverage], the insurer is not imposing conditions on its defense. The defense remains unqualified; the insurer, by reserving its rights, is merely putting the insured on notice of what the insurer believes are its existing rights under the policy.” *Id.*



might become moot if the insured is found to owe nothing to the plaintiff in the underlying action, and the insured receives something of value—a defense—in the meantime. But if the coverage reservation is coupled with the defense reimbursement reservation, the present value received by the insured is substantially reduced. The stark reality confronting the insured is that every expense being incurred in the defense could, conceivably, become the insured's responsibility at a later time.

Liability insurance contracts neither specify the procedures an insurer is to follow when reserving rights nor state the consequences of such a reservation. With respect to a reservation to deny the indemnity obligation at a later time, these omissions are not problematic. This kind of reservation presents no particular theoretical problem; its essence is the insurer putting the insured on notice that the performance of duty A (defense) should not cause the insured to understand that the insurer has agreed to perform duty B (indemnity) later. No value is transferred presently with respect to duty B, and whether such a transfer is even required is a question being postponed until a later time, perhaps indefinitely. Because the insurer does not propose taking something from the insured or seeking a return from the insured of something that the insurer will confer, there is no need to articulate a theory that authorizes a future reallocation of value. When a defense is provided, however, a transfer of value occurs; the insured receives a defense and the insurer pays for it. In the absence of a legal principle explaining why this value must be returned to the insurer, the insured should be allowed to retain what the insurer has intentionally, voluntarily conferred.<sup>116</sup> If the insurer and insured expressly contract, either in the insurance policy or at the time of the reservation, that the insurer shall have this right, the express agreement provides the authority for the reallocation.<sup>117</sup> In the usual case, however, this express agreement does not exist,<sup>118</sup> and the justification for the reallocation must be found in other sources. Restitution is the theory that has been offered to justify the reallocation (i.e., reimbursement of defense costs) that insurers desire. But the malleable principles of restitution, when brought to bear on the defense cost reimbursement issue, can

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116. Deeply embedded in the common law is a straightforward principle. When a person voluntarily donates property or services to another, this person has bestowed a gratuity upon the recipient, and the recipient is allowed to keep the property or the benefit absent some superseding doctrine requiring its return. This principle is most apparent in the law of donative transfers. See E. ALLAN FARNSWORTH, *CONTRACTS* § 2.5, at 51 (3d ed. 1999); IV PALMER, *supra* note 54, § 18.1, at 2 ("At common law, inter vivos gifts, that is, those intended to take effect during the donor's lifetime, are irrevocable unless expressly made revocable.").

117. See *supra* note 45 and accompanying text.

118. Such an express agreement could be placed in the liability insurance contract. However, as noted earlier, the liability insurance forms currently in widespread use do not speak to, let alone create, a reimbursement right. See *supra* text following note 28. In addition, the reservation of rights letter does not seek the insured's explicit assent to the reservation; rather, the reservation is a unilateral announcement of the insurer's intentions. For discussion of the differences between nonwaiver agreements and reservation of rights notices, see JERRY, *supra* note 1, § 114[c][3], at 795–98.

be deployed either to support or to defeat the insurer's right. This equivocation suggests the need for the discovery and application of a more determinant analytical approach.

As a threshold matter, restitution requires that the defendant have received a benefit.<sup>119</sup> This presents no particular difficulty in the situation of the insurer-provided defense, although it is worth noting that the insured's benefit is atypical when compared to that which the defendant receives in the paradigmatic restitution case. The thief, for example, is enriched at the expense of the victim,<sup>120</sup> and the recipient of an erroneously directed gift is enriched at the expense of the intended donee.<sup>121</sup> In such cases, the defendant's assets are tangibly enriched by the benefit. In contrast, the insurer-provided defense does not "inflate" the insured's assets, but instead simply prevents the insured's assets from being "deflated," i.e., the insured does not lose resources the insured would have spent if the insured had been forced to secure its own defense.

This distinction should not matter.<sup>122</sup> But if the existence of a valid restitution claim is predicated on an understanding of "benefit" which requires some kind of visible enhancement of a party's well-being, the distinction would become hugely important. To put this point in a fuller context, consider that when the insured tenders the defense of a claim to the insurer, the insured ordinarily takes the position that the insurer must provide the defense to satisfy its contractual obligations to the insured. If the insured's position is correct, it is fair to say that the insured is advantaged from the receipt of the insurer-provided defense, but this advantage is the insured's contractual entitlement and is, therefore, not unjustly received. If, however, the insured's position is incorrect and the insured receives a defense to noncovered claims, it is likewise fair to say that

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119. See RESTATEMENT OF RESTITUTION § 1, at 12–15 (1937). Section 1 states that "[a] person who has been unjustly enriched at the expense of another is required to make restitution to the other." Comment a states that "[a] person is enriched if he has received a benefit," and that "[a] person is unjustly enriched if the retention of the benefit would be unjust." *Id.* § 1 cmt. a. See also RESTATEMENT (THIRD) OF RESTITUTION § 1 cmt. b (Council Draft No. 1, 1999) ("Liability in restitution is triggered by the receipt of a benefit, under circumstances such that the recipient is not justified in retaining the benefit without paying for it.").

120. See I PALMER, *supra* note 54, § 1.1, at 3 (explaining restitutionary remedy for benefit received by thief). But see RESTATEMENT (THIRD) OF RESTITUTION § 1 cmt. b (Council Draft No. 1, 1999) ("Liability in restitution is triggered by the receipt of a benefit, under circumstances such that the recipient is not justified in retaining the benefit without paying for it."); *id.* § 1 cmt. c (Council Draft No. 1, 1999) (noting that restitution is unnecessary to explain why a thief must return stolen goods to the true owner). See also *supra* note 54.

121. See IV PALMER, *supra* note 54, § 18.9, at 69–91 (discussing restitution in favor of intended donee of gift mistakenly made to the wrong person).

122. See RESTATEMENT (THIRD) OF RESTITUTION § 2 cmt. c (Council Draft No. 1, 1999). ("Restitution is concerned with the conferral of benefits that yield a measurable increase in the recipient's wealth.... A saved expenditure or a discharged obligation is no less beneficial to the recipient than a direct transfer.").

the insured is advantaged through the receipt of a free service for which the insured would otherwise have been required to pay. This advantage is not a tangible, visible, or measurable enhancement in the insured's wealth; rather, the insured is advantaged only in the sense of being prevented from suffering an out-of-pocket loss. If, for example, one hypothesizes an insured who has no assets, one could plausibly argue that the insured has no out-of-pocket "loss" to suffer and thus, by extension, receives no "benefit" from the provision of the insurer-provided defense. However one describes the insured's side of the equation, the insurer suffers loss in an amount equal to the cost of providing a defense to noncovered claims. Thus, it is plausible to assert that the insurer's restitution claim in the foregoing context, unlike the more common situations where restitution is invoked, is aimed not so much at retrieving a benefit obtained by the insured—because there is nothing to be retrieved—but at compensating the insurer for an out-of-pocket cost that the insurer contends should have been incurred by the insured. In other words, the insurer's claim appears to be more in the nature of remedying the insurer's reliance, rather than disgorging the insured's benefit.

Whatever facial appeal might be embedded in the foregoing reasoning, it would abuse the settled law of restitution if such reasoning were embraced. Excluding expenditures that prevent another from suffering loss from the scope of "benefit" would constrict restitution's justice-enhancing role.<sup>123</sup> The commentary to section 1 of the *Restatement of Restitution* explains: "[A person] confers a benefit not only where he adds to the property of another, but also where he saves the other from expense or loss. The word 'benefit,' therefore, denotes any form of advantage."<sup>124</sup> Plainly, the insured that is defended for noncovered claims is advantaged in the sense of being saved from expense or loss, and this advantage is attained at the insurer's expense. Thus, an alleged lack of "benefit" to the insured is not a plausible basis for denying the existence of a reimbursement right.<sup>125</sup>

That the insured is benefitted by a defense to noncovered claims is obvious; whether the insured is *unjustly* enriched is less so. Restitution does not authorize recoupment of all benefits, but only benefits which, if retained, would unjustly enrich the party on which the benefit is conferred.<sup>126</sup> The "unjust" element of restitution is most difficult because it essentially involves a normative conclusion that it would offend conscience, notions of fair dealing, or equitable

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123. See *supra* text accompanying notes 50–57.

124. RESTATEMENT OF RESTITUTION § 1 cmt. b (1937). The proposed *Restatement (Third) of Restitution* is consistent with this conception of benefit. See *supra* note 122.

125. See *supra* text accompanying notes 65–75.

126. See RESTATEMENT OF RESTITUTION § 1 cmt. c (1937)

Even where a person has received a benefit from another, he is liable to pay therefor only if the circumstances of its receipt or retention are such that, as between the two persons, it is unjust for him to retain it. The mere fact that a person benefits another is not of itself sufficient to require the other to make restitution therefor.

*Id.*

norms if a benefit were received and not returned.<sup>127</sup> From the pro-reimbursement perspective, the argument favoring restitution is straightforward: The insured paid a premium to receive a defense to and indemnity for covered claims. No premium was paid for a defense to or indemnity for noncovered claims. Thus, when the insured receives a defense to a noncovered claim, the insured receives more than the contractual entitlement at the expense of another. The insured has no reasonable expectation of being allowed to retain the benefit, and it would be unjust if the insured does not pay the insurer for the extracontractual benefit it receives.<sup>128</sup>

If duress is a factor that causes a party to confer the benefit, the conferring party's case for restitution is strengthened.<sup>129</sup> Translated to the insured-insurer relationship, the argument is that the insured, bolstered by rules that allow the insured robust remedies in the event the insurer fails to perform its duty to defend,<sup>130</sup> essentially extorts the insurer's defense of noncovered claims. The insurer, arguably, faces a risk of forfeiture—the actual and consequential damages associated with breaching the duty to defend—that effectively coerces the insurer to defend noncovered claims.<sup>131</sup> The insured's hand is further strengthened by

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127. See LAYCOCK, *supra* note 65, at 524–25 (“The substantive law of restitution is largely devoted to distinguishing between just and unjust enrichments.... Unjust enrichment is in fact undefinable....”); I PALMER, *supra* note 54, § 1.7, at 41 (“Issues of considerable difficulty sometimes arise with respect to the question whether there is an enrichment, but in a much larger number of cases the problem is whether retention of a recognizable enrichment is unjust.”); Kull, *Rationalizing*, *supra* note 50, at 1226 (“The central problem of the law of restitution is to identify those instances of enrichment that the law regards as unjust.”).

128. This is the logic of the *Buss* decision. See *supra* notes 83–105 and accompanying text.

129. See RESTATEMENT (THIRD) OF RESTITUTION § 14 (Council Draft No. 1, 1999) (“A transfer induced by duress is subject to rescission at the instance of the transferor or a successor in interest.”); II PALMER, *supra* note 54, §§ 9.1–19.

130. See JERRY, *supra* note 1, § 111[h], at 752–60 (discussing remedies for breach of the duty to defend).

131. This argument is developed more fully by William Barker. See Barker, *supra* note 11, at 547–48. To support this argument, Barker analogizes to the situation sometimes faced by the insured with a life or disability policy containing a waiver of premium in the event the insured is totally disabled. If the insurer and insured disagree about whether the insured is disabled, the insured who suspends payment of premium runs the risk that he or she will forfeit coverage for nonpayment of premiums in the event the insurer's position turns out to be correct. But if the insured's payment of the premium were deemed voluntary and a right to restitution denied in the event the insured's position were vindicated, the insured would lose the benefit of the waiver of premium provision. Barker acknowledges that courts have split in their assessment of whether the insured's payment of premiums while the dispute is pending is made under duress, thereby entitling the insured to a refund of premiums paid in circumstances where the insured's position is vindicated. See *id.* at 547 & nn.31–32 (citing cases). An obvious difference between the disability situation and the reimbursement of defense costs issue is that the insured under a disability policy is a one-shot player, and lacks the expertise needed to adequately assess the risks of paying, or not paying, the premium. The insurer, in contrast, has considerable expertise and sophistication

information asymmetries that run against the insurer. With respect to the plaintiff's claim against the insured, the insured will often know the true facts about the insured's involvement, if any, in the circumstances giving rise to plaintiff's claim. That the insurer will have multiple sources of information is hardly guaranteed; indeed, the insurer may depend to a significant extent on the insured for the revelation of these facts. The insured's natural desire that the insurer fund the insured's defense provides an incentive for the insured to disclose facts in a manner that will maximize the probability that the insurer will provide a defense. The insured is constrained by the policy's requirement that the insured cooperate with the insurer, but the insured can be expected to test the limits of this duty if the insured's candor is likely to risk the loss of the insurer-funded defense. In these circumstances, the insurer is at the insured's mercy and is therefore entitled to restitution under the reasoning that the insurer provided, under duress, defenses to claims that turned out to be beyond the scope of the policy's coverage.<sup>132</sup>

Notwithstanding the superficial plausibility of the foregoing duress argument, its foundation is tenuous. Clearly, the potential consequences of breaching the duty to defend give the insurer a significant incentive to provide a defense when coverage is in doubt. Moreover, the risks to the insurer from not defending go far to undercut the argument, discussed in more detail below, that the insurer is a mere volunteer or officious intermeddler when it provides a defense to claims that prove to be outside the coverage.<sup>133</sup> But showing that someone is not

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when deciding the conditions under which it should undertake the defense of an insured. See Quinn, *supra* note 11, at 610.

132. See RESTATEMENT (THIRD) OF RESTITUTION § 14 cmt. d-III (Council Draft No. 1, 1999).

Coercive means are consistently held to be wrongful, notwithstanding that they may be both legally authorized and employed in good faith, to the extent that they induce a payment not due in respect of a subsisting claim.... The consistent pattern of decisions in such cases is explained by observing that a payment of money not due—the payment being made, and the true obligation measured, with reference to the parties' preexisting legal obligations—gives rise to *prima facie* unjustified enrichment and a claim in restitution to recover the excess.

*Id.*

An illustration in the Council Draft of the *Restatement (Third) of Restitution* could be read as giving support to this analysis:

Insurer requests in good faith that Policyholder pay an additional premium, announcing that it will cancel the policy if payment is not received. Policyholder correctly interprets the policy to provide that premiums have been waived. To avoid the risk of a lapse in coverage, however, Policyholder pays the premium demanded, then sues in restitution to recover the payment. Under the circumstances, Insurer's threat to cancel was wrongful; Policyholder's payment was involuntary; and Policyholder may recover the amount of the disputed premium.

RESTATEMENT (THIRD) OF RESTITUTION § 14 illus. 11 (Council Draft No. 1, 1999).

From the insurer's perspective in the reimbursement context, the following occurs: insured makes a good faith request for defense of a claim; insurer correctly interprets the

acting in the status of a volunteer is not equivalent to demonstrating that the person is acting under duress. Duress presupposes that the aggrieved party has no reasonable alternative.<sup>134</sup> The insurer, however, has multiple alternatives: defending unqualifiedly; defending under reservation; or declining to defend.<sup>135</sup> The insurer has expertise as a repeat player in the activity of assessing complaints and fact patterns and has considerable investigative resources at its disposal. The insurer's choice of alternative likely will reflect a calculated assessment of which course is in the insurer's best interest under the circumstances.<sup>136</sup> Policyholders can exploit information asymmetries to their advantage, but it is far from clear that even aggressive exploitation amounts to coercion of insurers as they consider how to respond to tenders of defenses when coverage is doubtful.

The pro-reimbursement perspective might also seek support in the cases where restitution is awarded under the reasoning that one party conferred a benefit on another by mistake. The mistake cases in the law of restitution are numerous<sup>137</sup> and the fact patterns are extraordinarily diverse. They include such situations as a party, for example, being mistaken about what is owed under a contract and

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policy as providing no coverage; to avoid the risk of damages for breach of the duty to defend, insured defends anyway and then seeks to recover cost of the defense.

The reimbursement context, however, is different. If the insurer correctly interprets the policy as providing no coverage and is confident of that interpretation, the insurer should decline to defend. The defense under reservation in that circumstance is, unquestionably, strategic, which cuts against the insurer's claim. See *infra* note 136 (discussing further the voluntary payment exception in this context). Moreover, when the threat inducing payment is a threat of civil litigation only, the threat is not wrongful and is, instead, "legalized coercion." RESTATEMENT (THIRD) OF RESTITUTION § 14 cmt. e (Council Draft No. 1, 1999). In *Restatement (Third) of Restitution*, the policyholder pays the premium to keep the coverage in force; in the reimbursement context, the insurer defends to counter the policyholder's good faith threat to seek damages in civil litigation for breach of the duty to defend. See RESTATEMENT (THIRD) OF RESTITUTION § 14 illus. 11. Thus, by this analysis, the insurer's defense under reservation does not occur under duress.

133. See *infra* notes 165–171 and accompanying text.

134. See RESTATEMENT (SECOND) OF CONTRACTS § 175 (1981) (stating that the elements of duress include an "improper threat by the other party that leaves the victim no reasonable alternative").

135. See *supra* note 109.

136. See RESTATEMENT (THIRD) OF RESTITUTION § 14 cmt. d–III (Council Draft No. 1, 1999) ("Properly understood, the doctrine of voluntary payment bars a claim in restitution only where the payor has assumed the risk that the payment is not in fact due, or where the payment is strategic."). Under the reasoning that the insurer defends claims for both the insured's and its own benefit and makes a strategic decision about whether to decline coverage or undertake the defense under reservation, it arguably follows that the insurer's acquiescence in the insured's request for a defense when coverage is in doubt is not coerced—that is, the insurer assumes the risk that the claim may not be covered.

137. Nine of the 23 chapters in the preeminent Palmer treatise on restitution are devoted to various aspects of mistake. See II, III & IV PALMER, *supra* note 54, §§ 12.1–20.17.

therefore doing more than his or her contractual obligation,<sup>138</sup> being mistaken about to whom something is owed and therefore performing for the wrong person,<sup>139</sup> being mistaken about the effect of a statute or other legal principle,<sup>140</sup> and being mistaken about the legal ramifications of a party's acts.<sup>141</sup> Because the results in these cases tend to be fact-dependent, it is virtually impossible to reconcile the outcomes.

Yet one of the unifying principles of the law of mistake is that the person who received a benefit by mistake should not be entitled, subject to some exceptions, to retain the benefit; such a retention would be "unjust," and the person should be required to return the benefit to the plaintiff, thereby restoring the plaintiff to the position occupied before the mistake was made.<sup>142</sup> In the insurance defense situation, the pro-reimbursement perspective can reason that the insurer, in defending a noncovered claim, has done so by mistake, and the benefits bestowed upon the insured ought to be returned. This position can draw upon the considerable number of cases recognizing an insurer's right to restitution of payments made to the wrong person,<sup>143</sup> under a mistaken assumption that a loss

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138. See, e.g., *Dorchester Exploration, Inc. v. Sunflower Elec. Coop., Inc.*, 504 F. Supp. 926, 937 (D. Kan. 1980) (stating that a buyer of natural gas who paid sellers a price increase eight months prematurely under erroneous belief that parties' contract required such payment, was entitled to restitution of the excess payment); *Talley v. Talley*, 566 N.W.2d 846, 853 (S.D. 1997) (awarding for unjust enrichment where contract for sale of cattle misinterpreted, resulting in an overpayment); 1 DOBBS, *supra* note 54, at 553 (stating that restitution is appropriate as remedy for mistakenly overpaying money).

139. See, e.g., *Stratton v. Hanning*, 294 P.2d 66, 68-69 (Cal. Ct. App. 1956) (upholding right of tenant to recover rental funds previously paid to one mistakenly believed to be owner of property); 1 DOBBS, *supra* note 54, at 553 (stating that restitution is appropriate as remedy for mistakenly delivering property to the wrong person).

140. See RESTATEMENT (THIRD) OF RESTITUTION § 5 (Council Draft No. 1, 1999) (stating that "[a] transfer gives rise to a claim in restitution if the transfer was induced by invalidating mistake[.]" and "[i]nvalidating mistake is a misapprehension of fact or law on the part of the transferor").

141. See RESTATEMENT OF RESTITUTION § 46 (1937) (discussing restitution for person who has conferred a benefit upon another because of an erroneous belief induced by a mistake of law that he or she is obligated to do so).

142. See *id.* ch. 2, Introductory Note.

There is no universal principle that one who makes a mistake in the conferring of a benefit is entitled to restitution. Nevertheless, if a benefit is conferred because of a serious mistake of fact by the transferor and he has not agreed to assume the risk of mistake, he is entitled to restitution unless the transferee or beneficiary is protected by virtue of the fact that he is a contracting party or a bona fide purchaser, or unless there is some other reason which makes it inequitable or inexpedient for restitution to be granted.

*Id.*

143. See RESTATEMENT (THIRD) OF RESTITUTION § 6 cmt. b. & illus. 5 (Council Draft No. 1, 1999) (discussing mistaken payment made to insured who has submitted no claim); JERRY, *supra* note 1, § 99[e], at 659 (stating that insurer who pays proceeds to

occurred,<sup>144</sup> or under a mistaken understanding about the insurance contract's provisions.<sup>145</sup>

The opposing argument emphasizes that the insurer is not "mistaken" about its performance, for in undertaking a defense in circumstances of uncertainty over coverage, the insurer has done exactly what it intended to do, with full knowledge and appreciation of the attendant uncertainty. In many situations, conscious, deliberate assumption of risk (i.e., proceeding in the face of uncertainty) takes away whatever entitlement one has to relief based upon mistake.<sup>146</sup> In fact, this theme is one that runs throughout the mistaken payment cases in insurance law. Where an insurer pays proceeds to a policyholder or beneficiary with awareness of the party's uncertain entitlement, the insurer's right to restitution is diminished, under the reasoning that the insurer assumed the risk of the mistake.<sup>147</sup> Moreover, there is a significant line of authority that emphasizes

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wrong person is ordinarily entitled to restitution (quoting *United States Fiduciary & Guar. Co. v. Reagan*, 122 S.E.2d 774, 780 (N.C. 1961))).

144. See RESTATEMENT (THIRD) OF RESTITUTION § 6 cmt. f-III (Council Draft No. 1, 1999) (discussing mistaken belief that cover loss has occurred); III PALMER, *supra* note 54, § 14.7, at 167; *id.* § 14.11, at 188-89 (stating that restitution probably will be allowed when life insurance is paid in the mistaken belief that the insured is dead, but noting some cases to the contrary when payment is based on a presumption of death after a long absence).

145. See RESTATEMENT (THIRD) OF RESTITUTION § 6 cmt. f-I. (Council Draft No. 1, 1999) (discussing mistake as to coverage); III PALMER, *supra* note 54, § 14.13, at 196-201 (discussing restitution where insurer mistakenly computes cash surrender value, amount of paid-up insurance, or period of extended insurance). See also *id.* § 14.14, at 201-09 (discussing restitution where insurer pays proceeds in ignorance of a fact that would be the basis for avoiding the policy).

146. See, e.g., *Kansas Farm Bureau Life Ins. Co. v. Farmway Credit Union*, 889 P.2d 784, 788-89 (Kan. 1995) (holding that insurer not entitled to relief based on mistake, given that insurer assumed risk that insured absentee was not dead when it paid life insurance proceeds to claimant); *Wray v. State Compensation Ins. Fund*, 879 P.2d 725, 728 (Mont. 1994) (stating that insurer's assumption of risk that claimant was permanently disabled bars equitable relief based on mutual mistake); *Demos v. Lyons*, 376 A.2d 1352, 1357-58 (N.J. Super. Ct. Law Div. 1977) (stating that bank's payment without checking sufficiency of buyer's account is assumption of risk that waives restitution claim based on mistake); RESTATEMENT (THIRD) OF RESTITUTION § 14 cmt. d-III (Council Draft No. 1, 1999) (stating that "the doctrine of voluntary payment bars a claim in restitution...where the payor has assumed the risk that the payment is not in fact due"). For discussion of assumption of risk as a basis for denying a contracting party's relief based on mistake, see RESTATEMENT (SECOND) OF CONTRACTS §§ 152-154 (1981).

147. See *Great Am. Ins. Co. v. Yellen*, 156 A.2d 36, 39-40 (N.J. Super. Ct. App. Div. 1959) (stating that insurer is entitled to recover mistaken payment unless it assumed risk of mistake); *Benson v. Travelers Ins. Co.*, 464 S.W.2d 709, 712 (Tex. Civ. App. 1971) (stating that insurer is entitled to recover amount of overpayment under collision insurance unless insurer assumed the risk of mistake); *Mid-Century Ins. Co. v. Brown*, 654 P.2d 716, 718-19 (Wash. Ct. App. 1982) (stating that insurer who pays proceeds under mistake of fact is entitled to restitution; an exception to general rule is triggered if insurer agreed to assume the risk of mistake). See generally JERRY, *supra* note 1, § 99[e], at 658-61. Also, if the



the need for finality of insurance payments, and these cases cut against insurers' claims for restitution for mistaken payments in many contexts.<sup>148</sup> To summarize, if the insurer's right to restitution for costs incurred in defending covered claims depends on how courts have handled insurers' requests for restitution of payments mistakenly made, how the defense cost reimbursement issue will be resolved is uncertain.

Given the weaknesses in the duress and mistake arguments, the reimbursement perspective is at its strongest when making a simple point: that the insurer's defense of noncovered claims, a performance for which the insured neither bargained nor paid, unjustly enriches the insured, and this entitles the insurer to restitution. The anti-reimbursement perspective, however, is not without significant counter arguments. Indeed, a court with pro-insured predilections can articulate a well-reasoned decision denying the existence of a reimbursement right.

Perhaps the strongest argument against reimbursement is based on the so-called "incidental benefits" exception.<sup>149</sup> The general principle is as follows: If a person (the "conferring party") who pursuant either to the performance of his or her own duty or to efforts to protect or improve the person's own interests incidentally confers a benefit upon another, the conferring party is not entitled to restitution from the benefitted party.<sup>150</sup> This principle explains some situations

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insurer pays proceeds to settle disputed claims, it follows that restitution is not appropriate, even if, in hindsight, it turns out that the facts were not such as to obligate the insurer under the policy. See III PALMER, *supra* note 54, § 14.7, at 169-70; *id.* § 14.11, at 189.

148. See III PALMER, *supra* note 54, § 14.11, at 188, 193 (citing representative cases).

149. See RESTATEMENT OF RESTITUTION § 106 (1937) ("A person who, incidentally to the performance of his own duty or to the protection or the improvement of his own things, has conferred a benefit upon another, is not thereby entitled to contribution."); II PALMER, *supra* note 54, § 10.7, at 418-22 (explaining that when plaintiff does work for another party and there is substantial economic equivalence between what plaintiff does and what plaintiff receives, plaintiff's recovery of incidental benefits would give plaintiff an "added gain for no justifiable reason").

150. The *Restatement* provision pertains to both performance of one's own duty and "protection or the improvement of [one's] own things." RESTATEMENT OF RESTITUTION § 106 illus. 2 (1937). Thus, for example, a party who drains a swamp on his own property and, in so doing, benefits adjacent property is not entitled to restitution. See *id.* The *Restatement* provision also refers to the conferring party not being entitled to "contribution." The preceding sections of the *Restatement* refer to situations where a party performing a duty or protecting his own interest is entitled to indemnity or contribution from a third party. See *id.* §§ 76-105. Generally, contribution refers to the situation where two or more parties are jointly responsible for the same obligation and one pays more than the share for which he or she is responsible; the party who pays more is entitled to contribution from the party who pays too little. Because the insurer and the insured are not jointly obligated, the law of contribution does not explain why the insurer might be entitled to reimbursement. See *infra* note 231. Section 106 states a principle that goes beyond the contribution setting, as some courts have recognized when applying the section to situations where joint obligors are not involved. See, e.g., *Dinosaur Dev., Inc. v. White*, 265 Cal. Rptr. 525 (Ct. App. 1989) (stating that property owner who built access road to landlocked

where justice does not require a party to return a windfall to the conferring party. For example, A's performance of a contractual duty owed B might benefit B in collateral, incidental ways that go beyond the value of the received exchange. To illustrate, A's construction of a beautiful home on B's lot might have the incidental effect of raising the value of unimproved adjacent property owned by B, but this enrichment is not unjust. The benefit has not been at A's expense given that A has suffered no loss, and A is not entitled to retrieve the benefit under the law of restitution.

The implication of the incidental benefits principle in the insurance defense setting is as follows: The insured's receipt of a defense for noncovered claims is, arguably, an "incidental benefit," which is justly retained and does not constitute unjust enrichment. To elaborate, if the insured is sued for both covered and noncovered claims in the same lawsuit, the insurer is obligated by the insurance contract to defend the covered claims, and insurance law places a further duty on the insurer to defend the noncovered claims as well, assuming it is impossible to segregate the covered allegations and their underlying facts from the noncovered ones. When the insurer defends the covered claims, it can be argued that the insured, receives collateral, incidental benefits—namely, a defense to the noncovered claims—from the insurer's performance of its contractual duty. The insurer has no entitlement to restitution for these incidental benefits, which justly belong to the insured.

A related point can be made by emphasizing how the insurer benefits itself by undertaking the defense when coverage is in doubt. The underlying idea is that if one confers a mutual benefit when acting to promote his or her self-interest, the benefitted party is not unjustly enriched.<sup>151</sup> Not defending is a dangerous alternative for the insurer, which risks liability for breach of the duty to defend if its doubts about the existence of coverage turn out to be unfounded.<sup>152</sup> The alternative of defending unqualifiedly causes the insurer to waive the position

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property not entitled to restitution for benefit to other property owners who benefitted from road); *Major-Blakeney Corp. v. Jenkins*, 263 P.2d 655, 664–65 (Cal. Ct. App. 1953) (stating that plaintiff's construction of sewer, paving, and street improvements in plaintiff's development, that incidentally benefitted adjacent property-owner, did not entitle plaintiff to restitution for benefit conferred on defendant).

151. See RESTATEMENT (SECOND) OF RESTITUTION § 2 cmt. d (Tentative Draft No. 1, 1983).

When an expenditure is made by one person to the advantage of himself and another, it is sometimes not evident whether any benevolence was intended or not.... In the cases here considered a person has provided benefit both for himself and for another, at expense to himself, by a decision on which he had an opportunity to reflect. The other person will usually have manifested assent to that decision, or at least have acquiesced in it.... [T]he fact of mutual gain does not indicate unjust enrichment, even when the cause is an expenditure on one side only.

*Id.*

152. See *supra* note 111.

it might wish to assert later—that the insurer owes no indemnity obligation.<sup>153</sup> Thus, defending under reservation, while beneficial to the insured, is also beneficial to the insurer because the insurer protects and furthers its own interests. The insurer retains control of the defense, which has been declared a valuable right in many contexts.<sup>154</sup> The insurer also retains control over any settlement with the plaintiff in the underlying action,<sup>155</sup> and the insurer has control over the choice of counsel, which is important to conducting the defense in a cost-effective manner.<sup>156</sup> Furthermore, the insurer obtains the benefit of insulating itself from liability for potentially large damages for breach of the duty to defend.<sup>157</sup> Thus, whatever benefits the insured receives in such circumstances are not unjustly received.

This last point—that the insurer defends noncovered claims for its own benefit—is one that some courts have found persuasive when denying insurers' requests for reimbursement,<sup>158</sup> and thus it must be credited as one of the stronger anti-reimbursement arguments. Yet the application of this principle in the insurance setting is not invulnerable.<sup>159</sup> The incidental benefits exception is

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153. See *supra* note 110.

154. See, e.g., Jerry, *supra* note 13, at 175 & n.73 (discussing and citing cases); Silver & Syverud, *supra* note 24, at 264–65.

155. See, e.g., JERRY, *supra* note 1, § 112, at 763–64; Silver & Syverud, *supra* note 24, at 264–65.

156. See, e.g., JERRY, *supra* note 1, § 111, at 731; Silver & Syverud, *supra* note 24, at 264–65.

157. The existence of these benefits to the insurer when defending under reservation was the basis for a pre-Buss California appellate court holding that the insurer was not entitled to reimbursement of defense costs. In *Travelers Insurance Co. v. Leshner*, the court explained:

The insurer who is uncertain whether coverage is provided under a policy undertakes the defense of its insured under a reservation of rights in large part to protect itself from a subsequent claim that it breached its agreement with the insured. Although the assumption of the defense by the insurer without doubt also benefits the insured, it is not primarily undertaken for the insured's benefit.

*Travelers Ins. Co. v. Leshner*, 231 Cal. Rptr. 791, 809–10 (Ct. App. 1986).

*Leshner* was approved in *In re Hansel*, 160 B.R. 66, 70 (Bankr. S.D. Tex. 1993), *Reliance Insurance Co. v. Alan*, 272 Cal. Rptr. 65 (Ct. App. 1990), and *Insurance Co. of the West v. Haralambos Beverage Co.*, 241 Cal. Rptr. 427, 434–35 (Ct. App. 1987). Also adhering to this analysis is *Federal Insurance Co. v. Susquehanna Broadcasting Co.*, 727 F. Supp. 169, 172 n.3 (M.D. Pa. 1989). *Leshner* was explicitly disapproved in *Buss v. Superior Court*, 939 P.2d 766, 776 n.12 (Cal. 1997). See also Richmond, *supra* note 11, at 503 (referring to the mutual advantage argument, states that “[i]t is here that insurers’ right to reimbursement of defense costs is weakest”).

158. See *Terra Nova Ins. Co. v. 900 Bar, Inc.*, 887 F.2d 1213 (3d Cir. 1989); *supra* text accompanying notes 77–80 (discussing *Terra Nova*); cases cited *supra* note 81.

159. The Buss court specifically addressed and rejected the “incidental benefit” rationale for denying the insurer a reimbursement right, but the inability of the court to articulate a compelling basis for rejecting the rationale is some evidence of the argument’s strength. In a footnote, the court, referring to the passage from *Travelers*, quoted *supra* note

arguably relevant only to situations where the conferring party performs the totality of its duty and no more—that is, where there is no expense of additional performance beyond the full performance that generates the benefits received.<sup>160</sup> The insurer who defends both covered and noncovered claims arguably does more than full performance; the insurer fully performs (by defending the covered claims) and “then some” (by defending noncovered claims). It is the “then some”—the excess performance rendered by the insurer—that confers the additional benefits. In other words, conceptualizing the insurer’s performance as “doing more than it owes” provides a rationale for escaping the incidental benefits exception altogether and appeals to the restitution cases allowing a party that “over-performs” its contractual obligation to recover the value of the excess performance from the benefitted party.<sup>161</sup> Indeed, in any contractual relationship, a party performs its contractual duty not only to further its own interests, which is why the party entered into the contract in the first instance, but also to protect its own interests, given that nonperformance of contractual duties exposes the party to remedies for breach. Denying restitution whenever a purpose of a party’s actions is

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157, stated: “Such reasoning fails. It turns on motive. Motive, however, is ‘hard...to discern.’” *Buss*, 939 P.2d at 777 n.14 (citation omitted). The court explained that the subjective motive of any individual person is often not apparent, and the same is true if a group of individual persons is the actor. As for a corporation or similar entity, the court explained that motive is “purely fictive.” *Id.* at 777–78 n.14. Again referring to the quoted passage, the court asserted that “[t]he analysis in the text does not attempt to fathom why the insurer acts as it does subjectively, but merely looks to what results from its action objectively.” *Id.* Whatever difficulties may exist in ascribing a subjective motive to an artificial person, it is indisputable that insurers defend under reservation of rights to avoid the potentially calamitous consequences of failing to defend a covered claim on the one hand and the potentially expensive concession involved if the claim is defended without reservation and subsequently turns out, to be a noncovered claim. The insurer defends under reservation to protect its own interests and things.

160. *Restatement of Restitution* section 106 refers to the conferring of a benefit “incidentally to the performance of his own duty,” implying that the benefit is one which arises out of the duty’s performance, not a performance beyond the scope of and thus not required by the duty. RESTATEMENT OF RESTITUTION § 106 (1937).

161. Professor Palmer observes that “[t]here is almost no useful authority when there has been a mistaken overperformance of an actual contract, corresponding in that aspect to the mistaken overpayment of a debt. In the latter instance restitution goes almost as a matter of course, but in the former there are factors working against restitution that must be taken into account.” III PALMER, *supra* note 54, § 14.5, at 162–63. The example which he then offers—a contractor’s mistaken construction of a five-room house when the contract only calls for four rooms—is distinguishable from the insurance defense situation because the insurer knows about the possibility that no coverage exists when it provides a defense. *See id.* § 14.5, at 163. This raises the question of to what extent the performer’s “doubt” about the obligation should affect the right to restitution, a subject to which Palmer devotes an entire section. *See id.* § 14.7, at 166–74. Although acknowledging that the body of case law is small, he contends that doubt, even substantial doubt, about what performance is owed should not prevent a finding of relievable mistake, and he offers numerous mistaken payment cases in insurance law to substantiate the point. *See id.* § 14.7, at 166–71. For more on mistake, see *supra* text accompanying notes 137–148.

to benefit the party's own interests emasculates restitution in all contractual contexts, given that some element of self-benefit always exists whenever a party undertakes to perform contract duties.<sup>162</sup>

To summarize, the incidental benefit argument, although persuasive to some courts, has uncertain reach and is therefore not conclusive on the question of the insurer's reimbursement right. It may gain some strength, however, from a second related argument which focuses on the insurer's control of the conferral of the benefit. In performing the liability insurance contract, the insurer determines, through its own independent assessment of the plaintiff's claims against the insured and its unilateral decisions about whether and on what terms to provide a defense, to what extent a benefit is conferred on the insured. The insured requests a benefit when it tenders the defense to the insurer, but the insured's request is made to preserve its rights under the contract. The insured does not control whether a benefit is received and does not induce it through the insured's own act or neglect.<sup>163</sup> As a passive recipient of a benefit deliberately and consciously bestowed by the conferring party, the insured is enriched, but this enrichment is not unjust. It is not essential that the benefitted party act affirmatively to seize a benefit in order to give the conferring party a right to recoup it, but passive beneficiaries tend to be on firmer ground should they subsequently face the conferring party's claim for restitution.<sup>164</sup>

A stronger version of this second argument claims that the insurer is a mere volunteer, or "officious intermeddler," and should be denied restitution for this reason.<sup>165</sup> The principal rationale for denying restitution in these circumstances

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162. An argument exists, however, that emasculating the idea that restitution is available in the context of contractual transactions would be a good thing. *See supra* note 57. Note, also, that the defense of noncovered claims is not, from the pro-reimbursement perspective, the performance of a contractual obligation.

163. A counter-argument, discussed earlier, is grounded in duress; the insured, it could be argued, can effectively coerce the insurer into defending noncovered claims. For a more detailed discussion of this argument and its critique, *see supra* text accompanying notes 129-135.

164. Thus, when a contractor improves the defendant's property by mistake, the contractor may be entitled to restitution, but the benefitted party's lack of knowledge, reasonable reliance, and inability to "unwind" the improvement all cut against restitution in this setting. *See* III PALMER, *supra* note 54, § 14.5, at 163-64. Likewise, a person who mistakenly receives an insurer's payment may not have to make restitution if he or she reasonably relies on it. *See* JERRY, *supra* note 1, § 99[e], at 659-60.

165. *See* RESTATEMENT OF RESTITUTION § 2 (1937) ("A person who officiously confers a benefit upon another is not entitled to restitution therefor."); *id.* § 112 ("A person who without mistake, coercion or request has unconditionally conferred a benefit upon another is not entitled to restitution, except where the benefit was conferred under circumstances making such action necessary for the protection of the interests of the other or of third persons."). The *Restatement (Second) of Restitution (Tentative Draft No. 1, 1983)* articulated the concept as follows: "A person who receives a benefit through conduct officious as to him does not owe restitution to the person so acting. A person acts officiously when he intervenes in the affairs of another without adequate justification, such as that which may be afforded by a request or a mistake." RESTATEMENT (SECOND) OF

devolves from the concern that a party might foist benefits upon unsuspecting people, using the law of restitution to create a right to payment for goods or services where none would otherwise exist.<sup>166</sup> To countenance such a right would encourage those who have no viable market for their products or services to make a living by trying to impose "deals" on persons who would prefer to be left alone. Another rationale comes from the concern that the defendant may have detrimentally relied on the receipt of the benefit, and that ordering its return might leave the defendant in a worse position than the defendant was in before the benefit was bestowed.<sup>167</sup> Although one could account for this reliance by allowing a setoff from the restitution recovery, measuring the amount of reliance may be difficult. Thus, a more pragmatic default rule is to deny restitution altogether except in narrowly defined circumstances, such as where the benefit was bestowed to protect the public health or falls into the category of "necessaries."<sup>168</sup> The argument from the anti-reimbursement perspective is that the insurer has multiple alternatives when a defense is tendered in circumstances where coverage is doubtful, and one of those alternatives is not to defend at all. In opting to defend under reservation, the insurer assumes the status of a "volunteer" and thereby loses the restitution remedy.<sup>169</sup>

Viewing the insurer in this setting as a "volunteer" is problematic at several levels. First, where a mixed action is involved, insurance law rules require

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RESTITUTION § 2 (Tentative Draft No. 1, 1983). The general principle is difficult in application, however. In referring to these principles, Professor Dobbs states that "[b]oth the rule and its terms may be misleading. The mistaken plaintiff is not always allowed to recover unsolicited benefits, and the plaintiff who is not mistaken sometimes is." 1 DOBBS, *supra* note 54, § 4.9(1), at 680.

166. This rationale is evident in *Restatement (Third) of Restitution (Council Draft No. 1, 1999)*, which states:

A person who intentionally confers a nonbargained benefit on another has no claim in restitution in respect thereof if the recipient's obligation to pay compensation would ordinarily be based on a contract between the parties, and if the circumstances of the transaction are not such as to excuse the person conferring the benefit from the ordinary necessity of basing a claim to payment on a contract with the recipient.

RESTATEMENT (THIRD) OF RESTITUTION § 2(2) (Council Draft No. 1, 1999).

As explained in comment e, "[c]onsiderations of justice as well as efficiency require, therefore, that voluntary transfers be made pursuant to contract wherever possible. The consequence for the law of restitution is that restitution is not normally available to the claimant who should have made a contract with the recipient but failed to do so." *Id.* § 2(2) cmt. e.

167. See 1 DOBBS, *supra* note 54, § 4.1(2), at 563 ("Innocent defendants must be protected where they have changed position after receiving the enrichment and where they would be placed under significant hardship if restitution is required of them.").

168. See *infra* note 173.

169. See Richmond, *supra* note 11, at 500-01 (stating that "[a]n insurer that defends an action in which all of the plaintiff's claims clearly are uncovered surely does so as a volunteer, such that no right to restitution will lie," but an insurer that defends a mixed action does not do so voluntarily).

the insurer to defend noncovered claims, which seriously undermines the suggestion that the insurer voluntarily bestows a benefit on the insured. Second, the insurer has an interest to protect (i.e., the insurer *might* be liable to defend because the underlying claim *might* be covered) and this should be enough to remove the insurer from the status of a volunteer.<sup>170</sup> Third, the insurer does not defend without request.<sup>171</sup> When the insured is sued, the insured tenders the defense to the insurer, which is tantamount to the insured's request that the insurer perform contractual obligations. The insurer who defends does so because of the compulsion of these obligations, thus undermining the argument that the insurer defends voluntarily.<sup>172</sup> Finally, it is at least plausible to argue, although the argument is a stretch, that the insurer's provision of a defense is akin to providing "necessaries," which is one circumstance where the volunteer can recover restitution.<sup>173</sup> To summarize, for a variety of reasons, the insurer who defends an insured pursuant to the obligations of a liability insurance contract is far removed from the officious intermeddler who seeks to impose deals on innocent beneficiaries.

A third reason the insurer's defense of noncovered claims arguably does not confer an unjust enrichment is pertinent to mixed actions. The insurer's duty to

170. See III PALMER, *supra* note 54, § 14.7, at 173 (explaining that if uncertainty exists as to which of two insurers is responsible to pay for a loss and one insurer pays it, that insurer will be granted restitution from the other on proof that the liability rested on the second; the first insurer is not a volunteer because, at the time of the payment, it might have been liable, which gave that insurer an interest to protect).

171. See II PALMER, *supra* note 54, § 10.1, at 360 ("[T]he minimum meaning of the term [volunteer]...is that the benefit was transferred *knowingly* and *without request* of the defendant.").

172. See RESTATEMENT (THIRD) OF RESTITUTION § 14 cmt. c—III (Council Draft No. 1, 1999).

Where payment is made in response to a claim that the payor knows to be unfounded, the restitution claim must surmount the traditional obstacle of the "voluntary payment doctrine." Properly understood, the doctrine of voluntary payment bars a claim in restitution only where the payor has assumed the risk that the payment is not in fact due, or where the payment is strategic.... Either inference is excluded where it appears that a payment of money not due has in fact been coerced.

*Id.* For more discussion, see *supra* note 132 and accompanying text.

173. See RESTATEMENT OF RESTITUTION § 113 (1937).

A person who has performed the noncontractual duty of another by supplying a third person with necessities which in violation of such duty the other had failed to supply, although acting without the other's knowledge or consent, is entitled to restitution therefor from the other if he acted unofficiously and with intent to charge therefor.

*Id.* The problem with the argument that the defense is "necessary" is that most of the cases recognizing the necessities exception involve the provision of critical goods and services (e.g., food, medicine, clothing, shelter) "usually considered reasonably essential for the preservation and enjoyment of life." *Id.* § 113 cmt. d. Legal services, at least in this context, seem to fall short of this standard. Moreover, in most of the cases, the benefits' conferrals "were not inspired primarily by self-interest." II PALMER, *supra* note 54, § 10.4, at 374.

defend noncovered claims in mixed actions is imposed by law—specifically, by courts applying settled principles of insurance law.<sup>174</sup> The contract does not impose this duty, but this arguably is beside the point. The insured's receipt of a defense to noncovered claims is not unjust given that the duty is one which courts have stated should exist and ought to be fulfilled. Indeed, it is reasonable to assert that whether a duty is imposed by law or contract, the insured expects that it will be performed.

A fourth argument devolves from the distinction sometimes drawn between implied-in-fact duties and implied-in-law duties. Implied-in-fact duties, or contract terms, arise from the parties' agreement and are considered to be implicit in the overall understanding of the parties.<sup>175</sup> Implied-in-law duties are obligations external to the parties' agreement, are not implicit in the parties' understanding, and descend upon the parties from norms external to the contract.<sup>176</sup> Arguably, the insurer's duty to defend noncovered claims is implicit in the agreement. The insurer promises to defend *suits* alleging covered claims, and this logically entails an implicit commitment to defend noncovered claims that cannot be segregated from the covered ones. If the duty to defend noncovered claims in some situations is something the insurer implicitly agrees to do, the insured's receipt of this benefit cannot be said to be "unjust."<sup>177</sup>

Finally, it is arguable that when the insurer provides a defense under conditions of known uncertainty, it does not follow that the insured's receipt of this defense is unjust.<sup>178</sup> As set forth above, the first three parts of the insurer's undertaking when it defends under reservation involves the insurer acknowledging the uncertainty of the scope of its duties in the given situation, stating that it will defend the insured despite this uncertainty, and advising that it may contest the duty to indemnify at a later time.<sup>179</sup> In such circumstances, the insurer knowingly assumes an understood risk when conferring the benefit, which stands in distinct contrast to the usual situations: where the benefitted party unlawfully seizes an unearned gain from a wholly innocent plaintiff;<sup>180</sup> where the plaintiff confers an excess benefit on the other party to a contract without awareness that the benefit is not owed;<sup>181</sup> where the plaintiff confers a benefit on the other party to a contract

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174. See JERRY, *supra* note 1, § 111[c][4], at 737–40 (discussing law relevant to insurer's duty to defend mixed actions).

175. See FARNSWORTH, *supra* note 116, § 7.16, at 499 (distinguishing implied-in-law terms from implied-in-fact terms).

176. See *id.*

177. Of course, if the insurer explicitly agrees to defend noncovered claims, which was the argument made by the dissent in *Buss*, the enrichment conferred on the insured is not unjust. See *supra* note 94.

178. The potential effect of "doubt" on a restitution claim based on mistake is discussed earlier. See *supra* note 161. See also *supra* note 136 (discussing effect of insurer's strategic decision to defend on insurer's restitution claim).

179. See *supra* notes 111–112 and accompanying text.

180. See *supra* note 120.

181. See *supra* note 138.



without awareness that the contract is unenforceable;<sup>182</sup> or where the plaintiff acts in an emergency to benefit another<sup>183</sup>—a circumstance where the law wishes to encourage quick decisions to act unburdened by time-consuming reflection over the extent to which compensation is likely to be forthcoming. Indeed, a default premise of insurance law is that doubts about coverage tend to go to the insured.<sup>184</sup> Where the insurer is uncertain about the scope of the coverage it has provided, in a given circumstance and opts to give the benefit of its doubt to the insured, it is not apparent why the insured's receipt and ultimate retention of this benefit in doubtful circumstances is "unjust."

The foregoing discussion has focused on whether, under established principles of restitution, the benefit received by the insured who is defended for some noncovered claims is one that unjustly enriches the insured, and the analysis is inconclusive. If one adopts a view of restitution that gives equal or transcendent weight to the plaintiff's loss, as distinct from the defendant's benefit,<sup>185</sup> the analysis is no more definitive. From the pro-reimbursement perspective, the insurer's loss is its out-of-pocket payment for a benefit to which the insured is not entitled under the contract. Yet it is not clear that this is a "loss" for the insurer. The duty to defend noncovered claims is imposed by law, as discussed above;<sup>186</sup> to the extent restitution is grounded in a theory that the plaintiff's losses should be restored, it is not obvious why a plaintiff who has acted pursuant to a pre-existing duty can be said to have suffered a loss deserving of restoration. Stated simply, if one is obligated to act, the cost of acting is not a compensable loss.

Moreover, if the insurer anticipates (as it might, given that insurers know about the duty, imposed by law, to defend some noncovered claims) that in a predictable percentage of defenses of insureds some noncovered claims will be defended, the insurer should be expected to collect premiums to cover these expenses, spreading the risk of defending noncovered claims across the pool of all insureds. If the insurer collects premiums to pay for defenses of noncovered claims, the insurer passes the cost of defending noncovered claims through to all insureds, and the insurer suffers no loss.<sup>187</sup> Of course, one might argue that all insureds in the risk pool suffer a *pro rata* share of the loss, and that the insurer functions as a proxy for all insureds to retrieve the benefit bestowed and thus restore the loss suffered by all insureds. The cost pass-through situation is a challenging one for the law of restitution, and the cases have not handled the problem consistently. The setting in which this issue has been most thoroughly

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182. See RESTATEMENT OF RESTITUTION § 16 (1937) (discussing restitution for a person who has paid money to another because of an erroneous belief induced by a mistake of fact that in so doing he or she is performing a contract with the other that is not subject to avoidance).

183. See *id.* § 114 (discussing restitution relating to performance of another's duty to a third person in an emergency).

184. See JERRY, *supra* note 1, § 25A[c], at 134–36.

185. See *supra* notes 73–75 and accompanying text.

186. See *supra* note 103 and accompanying text.

187. See Quinn, *supra* note 11, at 604.

considered is taxation, where the common fact pattern involves the state erring in the collection of a tax on sellers, which the sellers then urge ought to be refunded under a restitution theory.<sup>188</sup> The difficulty for the sellers' restitution argument is that the tax is typically passed through to buyers in the form of increased prices, so that the sellers suffer no loss. Courts have reached widely inconsistent results when sellers make such restitution claims,<sup>189</sup> and this foreshadows difficulty when the issue is confronted in the insurance context.

Nor is the analysis clarified if one focuses on an infringement to an interest of the plaintiff, as opposed to a loss suffered by the plaintiff.<sup>190</sup> The insured does not invade a protected interest of the insurer's when the insured exercises its contract right to request that the insurer provide a defense. Indeed, seeking a defense is a legitimate exercise of the insured's rights. Moreover, standard policy language requires that the insured give the insurer notice of the loss as soon as reasonably practicable or else risk forfeiting the coverage.<sup>191</sup> Indeed, it is in the insurer's interest that early notice occur.<sup>192</sup> If the insured does not act improperly in seeking a defense, it is difficult to argue that a protected interest of the insurer has been infringed when the insurer is presented with such a request and thereafter acts upon it.<sup>193</sup>

#### *D. Summary*

A reasoned argument can be made under the law of restitution that the insurer is entitled to reimbursement of defense costs expended in defending noncovered claims. Given the malleability of restitution, a reasoned argument can also be made that the insurer has no such right. The debatable parameters of restitution suggest that reliance on this body of law to decide the issue will not yield consistent results in the cases and will not provide either insurers or insureds with a dependable basis for predicting outcomes in cases of first impression. The next Part of this Article explains that, unlike restitution, contract law provides a principled and dependable framework for analysis. Under this alternative framework, an insurer who defends noncovered claims is entitled to reimbursement of costs incurred in defending such claims. Thus, courts that have used restitution to support the insurer's reimbursement right have reached the correct result, even if a superior rationale exists for this outcome.

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188. See III PALMER, *supra* note 54, § 14.20, at 246–58; William J. Woodward, Jr., "Passing-On" the Right to Restitution, 39 U. MIAMI L. REV. 873, 885–909 (1985).

189. See III PALMER, *supra* note 54, § 14.20, at 253–56 (discussing cases reaching different results).

190. See *infra* notes 73–75 and accompanying text.

191. See JERRY, *supra* note 1, § 81[a], at 523–24 (discussing insured's obligation to give prompt notice of loss).

192. See *id.*

193. See Quinn, *supra* note 11, at 604.

### III. INTERIM SETTLEMENTS OF UNLIQUIDATED CLAIMS AS A JUSTIFICATION FOR THE INSURER'S REIMBURSEMENT RIGHT

Although the law of restitution is distinct from contract, it is closely identified with contract because of the tendency to conceptualize legitimate claims for restitution as reflections of what the parties would have agreed to do had they thought or been able to bargain about the allocation.<sup>194</sup> It is, then, a relatively small step from a restitution-based justification of an insurer's right to reimbursement of costs incurred in defending noncovered claims to a contract-based justification. Specifically, this Part contends that the insurer's reimbursement right, if it is not the product of express agreement, inheres in an agreement implied from the conduct of insurer and insured—an agreement to settle on an interim basis the parties' dispute over whether the underlying claims against the insured are covered and, therefore, whether the insurer owes the insured a defense. Before exploring this implied agreement in the context of liability insurance defense, this Part first examines the concept of interim settlement in the context of general contract law principles.

#### A. Contract Law and the Concept of Interim Settlement

In circumstances where contracting parties disagree over the extent of one party's obligation to the other, the parties have essentially four alternatives: (1) doing nothing; (2) rescinding the contract; (3) negotiating a complete reallocation of all of the parties' obligations to each other; or (4) negotiating a commitment for full performance under reservation. Rescinding the contract (the second alternative) is rarely a satisfactory solution. That some kind of relationship between the parties is valuable is proved by the fact that the parties contracted with each other. Even as the parties disagree over what is owed under the contract, the parties would agree in many situations that a relationship on altered terms is preferable to having no relationship at all. In other situations, one party may no longer value the contract, but there is unlikely to be mutual assent that rescission is in the best interests of the parties. If the contract has been partly performed, it may be impossible to unwind it; in that event, rescission is not even an option.

Of the remaining alternatives, a negotiated *ex ante* settlement (the third alternative) is the best because the parties arrive at a mutually satisfactory resolution of their disagreement. Such agreements are, however, not always achievable. Imperfect information about the full range of possible gains and losses when combined with the insecurities accompanying the reality that the parties' first agreement failed to fulfill its intended purposes may prevent the parties from successfully renegotiating their relationship. Also, if one party (let alone both)

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194. See *supra* note 59. This claim for restitution is not unique; the same could be made for tort law. Because transaction costs and the uncertainty *ex ante* about who will commit torts upon whom precludes contracts about compensation for certain kinds of losses inflicted by one person upon another, tort law reflects what the parties would have agreed to provide as compensation if they had been able to bargain *ex ante* about the remedy.

perceives that the other has failed to comport with standards of good faith and fair dealing, the resulting strains in the parties' relationship may render efforts to renegotiate fruitless.

The "do-nothing" alternative (the first alternative) leaves the deal where it stands and the dispute unresolved. Nothing is done to alleviate the insecurity that accompanies disagreement. The party whose obligation is the subject of dispute will perform only to the minimum of what he or she believes is owed under the contract, lest he or she assume the burden of establishing a right to retrieve what was advanced to the other side. The disappointed recipient of this performance will evaluate whether this minimal performance constitutes a material breach entitling the recipient to suspend performance and perhaps treat his or her own duties as discharged.<sup>195</sup> It is possible that the contract's performance will disintegrate as the parties respond, sometimes correctly and sometimes incorrectly, with what they each believe is a proportional response to the other side's perceived shortfall in performance. As the spiral toward disintegration intensifies, the significance of the dispute for the parties will escalate in direct proportion to the other side's withholding of its contract performance. In fact, much more may be at stake than the mere loss of bargain; consequential damages, which are often considerably more substantial than the loss of the bargained-for exchange, may come into play.<sup>196</sup> If the party performing only minimally is subsequently determined to have committed a breach, this party may be responsible for potentially vast consequential losses, depending on whether, and to what extent, the foreseeability and certainty limitations apply to the particular circumstances.

Between the alternatives of doing nothing and renegotiating all terms of the deal rests a fourth alternative: full performance under reservation. If the party whose performance is the subject of dispute (the "performing party") has assurances that the other party will restore excess benefits received in the event it is determined *ex poste* that only a minimal performance was owed, the performing party may be willing to perform the full measure of the duty and postpone until

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195. Each parties' duties in a bilateral contract are conditioned on the absence of a prior material breach committed by the other side. Thus, an aggrieved party is allowed to suspend performance only if the other side's breach is material. A breach is material if the performance is insubstantial; that is, the substantial but incomplete performance of a duty is equivalent to an immaterial breach. For further discussion, see FARNSWORTH, *supra* note 116, §§ 8.15–16; at 579–87.

196. Damages to an aggrieved party's expectation interest when a contract is breached generally equal the loss in value of the other side's performance (i.e., the loss of the bargain) plus any other loss (i.e., incidental and consequential damages), less any cost or loss that the aggrieved party has avoided by not having to perform. See RESTATEMENT (SECOND) OF CONTRACTS § 347 (1981). The loss in value of the other side's performance will normally be capped by the value of that performance; but consequential damages are potentially limitless. The risk of liability for enormous consequential damage is one reason the unforeseeability and certainty limitations on damage recoveries emerged in the mid-nineteenth century. For more discussion, see FARNSWORTH, *supra* note 116, §§ 12.14–15, at 821–35.

later the resolution of the disputed claim.<sup>197</sup> From the performing party's perspective, this is advantageous because the other party receives the full measure of what he or she claims, thereby eliminating the possibility that the performing party might become liable for consequential damages. This is also advantageous to the party receiving the performance because full performance is received in the short run; even if the value of a portion of this performance must be refunded in the long run, the party has not incurred consequential losses, and has avoided the risk of being unable to prove the quantity of such losses or otherwise survive the effects of contract law's foreseeability and certainty limitations upon the damage recovery.<sup>198</sup> Also, the possibility that after receiving full performance the performing party will recalculate the costs and benefits of pursuing the disputed claim and decide to abandon it altogether should not be overlooked.

To state the foregoing relationships in other words, the full-performance-under-reservation response to a dispute involves an interim settlement of an unliquidated claim.<sup>199</sup> If A and B disagree in good faith about the extent of B's contract obligation to A, A's claim on B is unliquidated. A and B should be able to settle A's unliquidated claim on an interim basis on the following terms: B agrees to perform to the full measure of A's demand, but without conceding and while expressly reserving B's claim that B owes less to A. If it is subsequently determined that B owed A less, then B is entitled to recover the value of the excess performance B rendered for A's benefit. If it is subsequently determined that B owed A the full measure of what A demanded, B has already fully performed, thereby discharging B's duty.

In circumstances where A would suffer immediate loss should B render only partial (or no) performance, this interim arrangement is beneficial. First, B's full performance prevents A from suffering the immediate loss. Second, should it be subsequently determined that A was entitled to the full performance, the interim agreement is beneficial in that it prevents A from suffering (and B from being liable for) damages, including consequential damages. Indeed, A's refusal to accept B's offer of an interim settlement should foreclose A from recovering consequential damages that could have been avoided by accepting the offer.<sup>200</sup>

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197. This possibility is broached in the *Restatement (Third) of Restitution*: "The payor who knowingly satisfies an unjustified demand may prefer to litigate the controversy as a restitution plaintiff than as a defendant in the other party's contract action." RESTATEMENT (THIRD) OF RESTITUTION § 14 cmt. d-III (Council Draft No. 1, 1999). For reasons discussed earlier, whether courts will sustain insurers' claims in the posture of a restitution plaintiff is unpredictable. Yet, by the same logic under which one might desire to be a restitution plaintiff instead of a contract defendant, an insurer may prefer to seek reimbursement in the posture of a party pursuing claims reserved by contract as part of an interim settlement of an unliquidated claim, as opposed to being a defendant in the insured's action for breach of duty to defend.

198. See *supra* note 196.

199. An unliquidated claim is a claim which is disputed in amount. A liquidated claim is a claim with respect to which the amount is not in dispute.

200. This devolves from contract law's avoidability limitation, which, in the language of the *Restatement (Second) of Contracts*, holds that "damages are not recoverable

Third, if subsequent events cause B to rethink its position and to agree with A (or if new circumstances cause B to conclude that it is uneconomic to pursue the issue further), the dispute is mooted without either party expending resources to resolve it.

Interim settlements on these terms are not common, however, for several reasons. First, if the dispute between the parties is a serious one, it is likely to be accompanied by strains in the parties' relationship that make continued performance of contractual duties difficult. In such circumstances, an interim settlement, which necessarily involves continued performance of the contract, is unlikely to be the first thing that comes to both parties' minds. Second, the performing party (B in the foregoing example) surrenders certain strategic advantages if litigation becomes necessary to recoup what is alleged to be the excess benefit conferred. Specifically, the performing party, as the plaintiff in an action to retrieve the excess benefit conferred on the recipient party (A in the foregoing example), assumes the burden of proving by a preponderance of the evidence that the full performance rendered was not, in fact, owed. If, by way of contrast, that performance had been withheld (as opposed to being given under an interim settlement arrangement), then the recipient party would be the plaintiff who alleges that a full performance was not given; as the plaintiff, the recipient party would assume the burden of proving by a preponderance of the evidence that

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for loss that the injured party could have avoided without undue risk, burden or humiliation." RESTATEMENT (SECOND) OF CONTRACTS § 350(1) (1981). As generally applied, this rule requires the aggrieved party to accept reasonable substitutes offered by the other party: "If the party in breach itself offers to perform the contract on terms less favorable to the injured party, this may nevertheless be an offer of an appropriate substitute. Such an offer is not one of an appropriate substitute, however, if it is conditioned on the injured party's surrender of any claim to damages." FARNSWORTH, *supra* note 116, § 12.12, at 814. See also RESTATEMENT (SECOND) OF CONTRACTS § 350 cmt. e (1981). In the situation in the text, A contends that B would be in breach if B would give the smaller performance that B claims is owed, and B denies this. This is similar to illustration 14 in section 350 of the *Restatement (Second)*, where F (the letter designation has been changed from the *Restatement* to facilitate clarity in this note) contracts to sell a used machine to G for \$10,000, F breaches, and F offers to sell the same goods to G for \$11,000. See RESTATEMENT (SECOND) OF CONTRACTS § 350 illus. 14 (1981). In these circumstances, G cannot refuse F's offer and recover \$25,000 in consequential damages caused by F's breach, because these damages could have been avoided by accepting G's offer and then recovering \$1,000 from F for breach of contract. If, however, F's breach were its insistence that G accept an older and therefore less valuable machine as full satisfaction of F's performance under the contract (as opposed to charging a higher price for the same machine), under the same logic G could not refuse F's offer and also recover consequential damages caused by F's breach. Assume, further, that F claims it is obligated only to deliver the older version of the machine, meaning that whether F is in breach is the subject of a good faith dispute. The interim settlement in these circumstances would have F deliver the machine to which G claims it is entitled, while reserving its right to obtain a reimbursement should it establish that G was entitled to only the older version of the machine. Under the logic of illustration 14, G could not refuse this offer while preserving its claim for consequential damages caused by F's nonperformance.

the performing party breached the contract (i.e., incompletely performed). In addition, the performing party may sense strategic disadvantage in attempting, in the role of a plaintiff, to convince a fact-finder that the performance was not owed, given the performing party's willingness to give that performance under the interim settlement. Third, the performing party may have legitimate concern that the other party will be unable to return the value of the excess performance rendered or to pay any judgment that the performing party might obtain.<sup>201</sup> Refusing to perform, thereby forcing the other party to sue for the performance, avoids this risk. Of course, the party who believes he or she owes less than the other side expects must weigh these disadvantages against the benefits of full performance under reservation. Depending on the circumstances, the party might conclude that the consequential damage risk associated with an *ex poste* determination rejecting that party's more limited view of its contract obligations outweighs the disadvantages of the interim settlement, and that the contract's performance should proceed in accordance with the other side's view of what is owed, subject to an agreement between the parties to resolve the dispute over what is owed at a later time.

A legitimate concern with interim settlements is that if B is a repeat player with more expertise in the subject transactions than A,<sup>202</sup> B might routinely claim that B is not liable, either in part or at all, to A, and attempt to structure interim settlements for all of its performances under all contracts it has with all parties. If B's claim that less was owed is asserted after full performance pursuant to an interim settlement and if A is correct that B's obligation was liquidated, B will, of course, lose its claim and A is protected. Indeed, it is unlikely that post-full performance claims will be routinely asserted by parties like B in situations where the claim is illegitimate. If B is a rational participant in the market, B will not systematically pursue claims it is likely to lose and incur the transaction costs associated with bringing such actions.

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201. An escrow arrangement can relieve these concerns, thus making an interim settlement of an unliquidated claim more palatable to the payor. In *Sears v. Grand Lodge A.O.U.W.*, 57 N.E. 618 (N.Y. 1900) (discussed in III PALMER, *supra* note 54, at 167-68), the insurer, after the insured had been missing for seven years, entered into an agreement with the beneficiary pursuant to which \$666, a portion of the proceeds, were paid forthwith and "not to be returned in any event," with the balance to be placed in escrow for 15 months and then paid to the beneficiary if the company failed to show reasonable proof that the insured was alive. *Id.* at 376. Before the \$666 was paid, the insurer demonstrated that the insured was living, and the insurer refused to pay any proceeds. The beneficiary's claim for the \$666 was upheld, under the reasoning that this sum represented a compromise of a disputed claim through an agreed exchange of values, with the insurer bearing the risk that the insured might be alive. *See id.* at 376-77. If, in this instance, one term of the settlement had been that the beneficiary would reimburse the insurer's \$666 payment in the event the insurer could establish that the insured was living, then this agreement would more closely resemble the interim settlements discussed in this section, and the insurer's reimbursement claim would be enforced in a case where the insured's continued living were established after the payment was made.

202. As discussed in the next subsection, *see infra* text accompanying note 225, an insurer is a repeat player in insurance matters, whereas an insured usually is not.

The repeat player concern is of a different sort. Because responding to a reimbursement action entails costs for the defendant,<sup>203</sup> the concern is that B will use the threat of a subsequent recoupment action to hammer down what A is willing to presently accept to discharge B's liquidated obligation. Indeed, B might, as a matter of customary practice, only give full performance under reservation and threaten to subsequently seek to recoup part of what B performed for A. Even if B has no intention to pursue reimbursement, the threat of doing so might be sufficient to coerce some of the parties with whom B deals to give up some benefits of the contract in order to avoid the subsequent costs of defending against B's reimbursement claim. This problem is not, however, unknown to contract law. Machinery exists to regulate, and hopefully deter, parties like B from threatening a reimbursement action to extort A's assent to an arrangement under which B would make a partial payment in full satisfaction of B's total obligation to A. For example, if B's performance is liquidated, i.e., is not the subject of a good-faith dispute, contract law is clear that B cannot discharge its duty through A's consent to accept less than the whole performance.<sup>204</sup> This is one way contract law responds to the concern that a party to whom a liquidated debt is owed might surrender the claim under coercion. The general principle, simply stated, is that liquidated debts cannot be discharged through payment of less than the whole.<sup>205</sup>

The foregoing general principle is, however, limited in the sense that the coerced party's entitlement is to restore the *status quo ante*—in other words, parties who subsequently realize they were pressured to abandon legitimate contract rights may retrieve their former positions. But if such parties accept partial settlement and do not thereafter complain, the injustice escapes sanction and further attempts to extort benefits through illegitimate discharges might be encouraged. Those contracting parties who believe that a significant number of substitute agreements will never be challenged (and who are not otherwise motivated to conduct themselves in accordance with standards of good faith and fair dealing) will not be deterred from seeking to coerce discharges through partial payments. From the coercing party's perspective, the worst that can happen is that some substitute agreements will be challenged, and the coercing party will be forced to pay what he or she agreed *ex ante* to pay anyway; to the extent challenges are not made for some agreements, the coercing party profits.

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203. The most obvious costs are attorney fees and other expenses associated with defending against the insurer's lawsuit.

204. See RESTATEMENT (SECOND) OF CONTRACTS § 278 cmt. c (1981) (stating that "part performance by an obligor of a duty that is liquidated and undisputed is not consideration for a discharge of that duty in full, even if the obligee so accepts it," and also noting criticism of rule in circumstances where no unfairness exists in such a settlement); *id.* § 73 ("Performance of a legal duty owed to a promisor which is neither doubtful nor the subject of honest dispute is not consideration."); *id.* § 74 (discussing rules pertaining to forbearance to assert or surrender of claim or defense which proves to be invalid).

205. The case most often cited for the general principle is *Foakes v. Beer*, 9 App. Cas. 605 (H.L. 1884), a decision which finds its way, through principal case or note, into virtually every contracts casebook used by first-year law students.



The party seeking to escape contractual obligations through part payments acts, however, at some peril. At a minimum, when B's obligation to A is liquidated, B's claim that less than full performance is owed makes A insecure. This triggers the rules that allow A to request adequate assurance of performance; B's failure to provide that assurance will constitute a repudiation of the contract, which will allow A to suspend its performance under the contract and proceed immediately to seek remedies for breach.<sup>206</sup> Moreover, if A is confident that B has stated an intent to commit a material breach, A might skip the assurance of performance machinery and take the position that B has repudiated the contract, which, if correct, entitles A to remedies for breach and relieves A from its contract duties.<sup>207</sup> Furthermore, although a number of courts have been wary of concepts like "good faith" and "fair dealing," it is appropriate to view B's attempt to discharge a liquidated claim with less than full performance as a material breach of the contractual duty of good faith and fair dealing owed by all parties with respect to contract performance,<sup>208</sup> which is relevant to determining whether B's failure to render or offer to perform is a material breach.<sup>209</sup>

If the foregoing is not enough to deter coercing parties from routinely threatening reimbursement actions in order to induce discharges of liquidated debts through partial payments, one would hope that the pressures of competitive markets will force contracting parties to abide by standards of good faith and fair dealing. To the extent the sharp practices of those seeking to escape contract obligations become known in the market, the number of people willing to contract with the opportunists will decline. Where competition is insufficient to force fair dealing and to deter parties from seeking to discharge contractual obligations through partial payments, governmental regulation—such as that which is pervasive in the insurance industry—might be needed to secure the behavior that market forces are unable to induce.<sup>210</sup> In some markets, judicial intervention—through, for example, recognition of the tort of bad faith—occurs. This kind of

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206. See RESTATEMENT (SECOND) OF CONTRACTS § 251 (1981) (describing when failure to give assurance may be treated as repudiation). This rule is a matter of statutory law for contracts for the sale of goods. See U.C.C. § 2-609 (1978). "Whether there is a right to assurance under contracts other than those for the sale of goods is still unclear, [with] some courts extending UCC 2-609 by analogy and others declining to do so." FARNSWORTH, *supra* note 116, § 8.23, at 616.

207. See RESTATEMENT (SECOND) OF CONTRACTS § 253 (1981) (stating that where obligor repudiates duty prior to breach by non-performance, repudiation gives rise to claim for damages for total breach and discharges the obligee's remaining duties to render performance).

208. See *id.* § 205 ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.").

209. See *id.* § 241(e) (stating that "the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing" is significant to the determination of whether the party has committed a material breach).

210. For discussion of insurance regulation as a response to market failures, see JERRY, *supra* note 1, § 20, at 51-54.

regulation might be explained as that which naturally arises when both competitive pressures and direct governmental intervention are inadequate.<sup>211</sup>

### *B. Interim Settlements in the Liability Insurance Context*

It is a common practice for insurers to provide defenses under a reservation of right to contest coverage at a later time,<sup>212</sup> and this procedure is properly understood as an interim settlement of an unliquidated claim. The insured who has been sued contends that the plaintiff's allegations in the underlying action are covered, and that, therefore, the insurer owes a duty both to defend the insured and to provide indemnification against any resulting judgment. The insurer doubts that coverage exists, but without further investigation the insurer is unwilling to take the unequivocal position that no coverage exists. In such circumstances, the insured's claim upon the policy is the subject of a good faith dispute and is, hence, unliquidated. Rather than deny coverage, the insurer proposes the following arrangement to the insured: The insurer offers to defend the claim at its expense but reserves the right to contest coverage at a later time and obtain reimbursement of defense costs incurred in the event it is demonstrated that coverage does not exist.<sup>213</sup> The insured accepts this offer, realizing that, whatever disagreements the insurer and insured might have, it is preferable in the short run to receive the benefit of the insurer's performance of the defense obligation.<sup>214</sup>

If the insurer and insured expressly agree to the foregoing interim settlement, a "nonwaiver agreement" is created.<sup>215</sup> The nonwaiver agreement is a bilateral contract, under which the insurer and insured jointly recite that the insurer's defense of the insured shall not be understood as the insurer's waiver of its right to later contest coverage and, perhaps, also seek reimbursement of defense costs incurred. In insurance defense practice, nonwaiver agreements are much less common than the insurer's practice of unilaterally sending the insured a reservation of rights letter, in which the insurer announces—and does not specifically invite the insured's assent—that it is providing the defense under a

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211. For discussion of the tort of bad faith in the insurance context, see JERRY, *supra* note 1, § 25G, at 151–62.

212. See *supra* notes 111–112 and accompanying text.

213. Exactly what the insurer would be entitled to recover in the event the actual facts show that no coverage, in fact, existed depends on how the court in question views the duty to defend—in other words, whether the jurisdiction follows the "eight corners" or "potentiality" rule. See *supra* text accompanying notes 33–40. If, for example, the jurisdiction follows the potentiality rule and the actual facts show that no coverage, in fact, existed but there was nevertheless a "potential" of coverage at certain times, the insurer would be entitled to reimbursement for defense costs only after it became clear that there was no potential of coverage or for defense costs incurred in defending those claims in a mixed action for which there was no potential of coverage. These questions are beyond the scope of this Article, but will be explored in a forthcoming piece on the subject.

214. See *supra* text accompanying note 198.

215. For more discussion of nonwaiver agreements, see JERRY, *supra* note 1, § 114[c][3], at 795–98, and *supra* note 118.

reservation to later contest coverage and, perhaps, seek reimbursement of defense costs.<sup>216</sup> There are several reasons the nonwaiver agreement is relatively rare. Securing policyholders' assent to the nonwaiver agreement involves additional transaction costs (i.e., it is easier to send a letter than to secure the insured's assent to a collateral agreement). Doubt exists as to whether the policyholder can sign the agreement without the advice of independent counsel.<sup>217</sup> And, at least where the insurer wishes to preserve the ability to later contest the indemnity obligation, the insured's assent to the reservation is unnecessary.<sup>218</sup>

That the insured's expressed assent to the insurer's reservation is unnecessary is beyond serious dispute when the insurer's performance of contract obligation "A"—the defense obligation—is independent of the insurer's contract obligation "B"—the indemnity obligation.<sup>219</sup> Because a reservation of right to seek reimbursement of defense costs involves the insurer performing obligation "A"—the defense obligation—while reserving the right to take back some of that performance at a later time, it does not necessarily follow that the logic favoring unilateral reservation of rights to contest independent duties is appropriate when the reservation involves taking back a portion of what the insurer intends to provide. In other words, the question is whether the general principle—unilateral reservations are permissible, and the policyholder's expressly manifested assent is unnecessary—changes when the reservation concerns the performance which is being rendered for the policyholder, that is, when the reservation pertains to the insurer's defense obligation.<sup>220</sup>

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216. See Richmond, *supra* note 11, at 469–70.

217. See JERRY, *supra* note 1, § 114[c][3], at 796.

218. See 1 WINDT, *supra* note 25, § 2.17, at 67–69; *id.* § 2.19, at 70–71 (noting that "a reservation of rights letter and a nonwaiver agreement provide the insurer the same amount of protection"); Richmond, *supra* note 11, at 506 ("In most states, the insured need not consent to the insurer's reservation of rights in order for it to be effective.").

219. For discussion of the independence of these duties, see *supra* text accompanying notes 14–19.

220. A similar question can be asked of the indemnity obligation: Is it possible, in circumstances where the defense is being provided under reservation to contest coverage, for the insurer to settle the underlying litigation and reserve a right to obtain reimbursement of the settlement amounts in the event it is determined that the plaintiff's claim(s) against the insured are outside the coverage? In this situation, like the reimbursement of defense costs situation, the insurer performs an obligation—indemnity—while reserving a right to claim that the indemnity duty was not owed on account of lack of coverage and to retrieve the funds that were advanced to resolve the underlying claim. Most courts to consider this question have held that the insurer can obtain reimbursement of settlement funds if the insured has authorized the settlement and agreed to reimburse the insurer in the event the insurer prevails on the coverage issue, or if the insurer has notified the insured of a reasonable offer and given the insured the opportunity to assume the defense. See, e.g., *Mt. Airy Ins. Co. v. Doe Law Firm*, 668 So. 2d 534 (Ala. 1995); *Johansen v. California State Auto. Ass'n Inter-Ins. Bur.*, 538 P.2d 744, 750 (Cal. 1975); *Val's Painting and Drywall, Inc. v. Allstate Ins. Co.*, 126 Cal. Rptr. 267, 273–74 (Ct. App. 1975); *Medical Malpractice Joint Underwriting Ass'n v. Goldberg*, 680 N.E.2d 1121, 1127–29 (Mass. 1997); *Matagorda County v. Texas Ass'n of Counties County Gov't Risk Mgmt. Pool*, 975 S.W.2d

When the relevant principles of contract law are brought to bear on the question, it is clear that the answer—the insured's expressly manifested assent is unnecessary—does not change. Assume that X has a bilateral contract with Y, and that the parties disagree about the scope of Y's contract obligation, the performance of which requires X's cooperation to some extent. In simple terms, X contends that Y must do more, and Y contends that Y owes X less. Y is unwilling to give the performance which X demands that Y provide if that means surrendering Y's claim that Y owes X less. Y is willing to give a more limited performance, but X is unwilling to accept Y's limited performance. Y, of course, cannot force its limited performance upon X. Y, however, is willing to perform in the more expansive manner that X demands on the condition that X commits to reimburse Y for the costs of Y's performance beyond that which Y contends it owes should Y later succeed in establishing that Y, in fact, owed X less. When Y tenders this proposed interim settlement, X has two alternatives: accept Y's proposal or decline it. If the proposal is accepted, the dispute over the scope of Y's duty is postponed to a later day. If the proposal is declined and Y's performance is not forthcoming, X is relegated to entering into a substitute transaction with another party and pursuing whatever remedies X has against Y for breach. Whether X will recover in its action against Y will depend on the merits of the underlying dispute between X and Y.<sup>221</sup>

In addition to either accepting or declining Y's offer of an interim settlement, does X have a third alternative—declining Y's offer but taking the benefit of Y's performance? In other words, can X accept Y's performance while simultaneously rejecting the condition Y attached to it? The answer is, and must be, no. Under contract law's principles of offer and acceptance, one cannot accept a tendered performance while unilaterally altering the material terms on which it

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782 (Tex. Ct. App. 1998), *review granted* (June 29, 1999). This, however, is not inconsistent with the analysis, developed in the text, that the insured's express agreement to the insurer's claim of right to reimbursement of defense costs is not needed. As with reimbursement of defense costs, *see supra* note 45, a specific policy provision authorizing reimbursement of settlement funds in the event the insurer prevails on the coverage issue is enforceable. *See National Cas. Co. v. Lane Express, Inc.*, 05-96-00444-CV, 1999 WL 219437 (Tex. Ct. App. Apr. 16, 1999).

221. Note that X should be foreclosed from recovering consequential damages, under the reasoning that these damages could have been avoided by accepting Y's offer of an interim settlement. *See supra* note 200. In the insurance setting, however, this outcome is not certain. For example, most courts have held that when an insurer breaches its duty to defend, the insured takes no steps to arrange for substitute counsel, and a default judgment is entered, the insurer assumes the risk that the insured will hire no attorney and the insurer is responsible for the default judgment up to the policy limits. *See JERRY, supra* note 1, § 111[i], at 760–62. This answer rejects the view that the insured's idleness in response to the insurer's breach is a failure to take appropriate steps to avoid the foreseeable consequences of the insurer's breach. Extending from the logic of these cases, it could be held that an insurer, when offering an interim settlement proposal, assumes the risk of the insured's noncooperation in response to the insurer's refusal to provide a full, unqualified defense.

was offered.<sup>222</sup> Thus, X cannot accept Y's offer while simultaneously altering one of its material terms; that is, X cannot decline Y's offer of an interim settlement while taking the benefit of Y's performance.<sup>223</sup> In other words, X's acquiescence in and acceptance of the benefits of Y's performance constitute a manifestation of acceptance of the terms on which Y's performance was tendered.<sup>224</sup>

The preceding section discussed the concern that repeat players, lacking regard for considerations of good faith and fair dealing, might routinely propose interim settlements as part of a strategy of hammering down what the other party will accept to discharge a liquidated claim. Translated to the insurance defense setting, the insured's concern is that some insurers will routinely defend under a reservation to seek reimbursement of defense costs in order to coerce insureds to accept partial defenses or disadvantageous settlements. If coverage is legitimately in doubt, the defense under reservation is not improper.<sup>225</sup> If, however, the

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222. See RESTATEMENT (SECOND) OF CONTRACTS § 59 cmt. a (1981). ("A qualified or conditional acceptance proposes an exchange different from that proposed by the original offeror. Such a proposal is a counter-offer.... The effect of the qualification or condition is to deprive the purported acceptance of effect."). See also *id.* § 19(2) (stating that conduct of a party manifests assent if the party "intends to engage in the conduct and knows or has reason to know that the other party may infer from his conduct that he assents").

223. This fact distinguishes cases involving an insurer's claim for reimbursement of settlement expenditures because the underlying claims were found to be outside coverage. Counsel appointed by the insurer cannot defend the insured without the insured's cooperation and acquiescence in the lawyer's appearance on the insured's behalf in the underlying litigation. In other words, the insured must at least tacitly agree to accept the lawyer's services; thus, there is no need to append an additional "explicit agreement" requirement as a prerequisite to the insurer's reimbursement right. In contrast, a settlement of the underlying action can occur without the insured's cooperation; thus, the cases deciding the insurer's reimbursement right have opted, for the most part, to require the insured's agreement or specific authorization to the settlement. See cases cited *supra* note 220.

224. This principle is recognized in some of the cases which recognize the insurer's reimbursement right. See, e.g., *Walbrook Ins. Co. v. Goshgarian & Goshgarian*, 726 F. Supp. 777, 784 (C.D. Cal. 1989) (stating that insured's acceptance of defense adequate to show insured's "understanding" of insurer's right to reimbursement, even if insured objects to the reservation of rights); *Omaha Indem. Ins. Co. v. Cardon Oil Co.*, 687 F. Supp. 502, 505 (N.D. Cal. 1988) (requiring agreement or understanding; insured's silence while acquiescing in insurer's provision of defense pursuant to explicit reservation is sufficient to enable insurer to recover defense costs), *aff'd*, 902 F.2d 40 (9th Cir. 1990); *Frank and Freedus v. Allstate Ins. Co.*, 52 Cal. Rptr. 2d 678, 686 (Ct. App. 1996) (observing, in dicta, that "the law permits an insurance company to condition an acceptance of defense on a later right to contest coverage or to seek reimbursement of defense costs"). But see *State Farm Fire & Cas. Co. v. Thomas*, 756 F. Supp. 440, 445-46 (N.D. Cal. 1991) (stating that for an insurer to obtain reimbursement, "the record must reflect 'an understanding between the parties'"; insured's silence in response to letter reserving right to reimbursement, even though insured accepted defense, is not an agreement or understanding between the parties).

225. See *supra* notes 112-113 and accompanying text.

existence of coverage cannot be the subject of a good faith dispute, the insurer's practice would be tantamount to attempting to discharge a liquidated claim through less than full performance.<sup>226</sup> In such circumstances, the insured who has second thoughts and decides to challenge the discharge *ex poste* would be entitled to restoration of the *status quo ante*.<sup>227</sup> Moreover, the insurer's practice would be vulnerable to attack on grounds that the announced intention to do less than a full, unqualified defense constitutes a repudiation of the contract, thereby entitling the insured to whatever damages can be proved and to suspend the performance of its own duties.<sup>228</sup> Of greater concern to the insurer should be the possibility that a court would find the insurer to have breached the covenant of good faith and fair dealing, which in some jurisdictions triggers the award of tort damages.<sup>229</sup> Moreover, a pattern of conduct of this sort should attract the interest of insurance regulators, who presumably would seek to discipline the insurer appropriately. One hopes, of course, that competitive pressures in the market place would render such judicial and administrative remedies unnecessary.

The implications of the foregoing analysis is that the insurer has a right to reimbursement for costs incurred in defending noncovered claims, assuming that the insurer reserves its right to assert the reimbursement claim before it undertakes the defense. An express agreement between insurer and insured that the insurer has a reimbursement right is enforceable. Absent such an agreement, most courts and commentators have reasoned that the right exists pursuant to the law of restitution. This view is not unanimously held, however, and the malleability of the law of restitution allows plausible arguments to be asserted in support of the divergent views. If restitution law remains the framework for deciding the issue, one can anticipate courts in jurisdictions that have not yet considered the question reaching inconsistent results. As explained in this section, the insurer's unilateral reservation of the right to seek reimbursement preserves the right if the insured accepts the benefits of the defense provided by the insurer. Thus, courts that have recognized a right to reimbursement based on restitution have reached the correct result, even though there is a firmer foundation for that outcome in the law of contract and the concept of interim settlement of an unliquidated claim.

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226. See *supra* notes 204–205 and accompanying text.

227. Efforts to settle liquidated claims by giving less than what is owed in exchange for an immediate release are unenforceable. See *supra* note 119. If the settlement is invalid, the liquidated claim remains due and owing, meaning the *status quo ante* is restored.

228. The damages suffered by the insured are likely to be nominal. The insurer who offers a qualified defense, i.e., one accompanied by a reservation of rights, still promises to defend the insured fully in the underlying action. More significant is the insurer's loss of its right to insist upon the insured's performance of its duties, such as the duty of cooperation, and to insist that all conditions to the insured's rights be satisfied.

229. See JERRY, *supra* note 1, § 25G, at 151–58 (discussing the insurer's liability in tort for breach of duty of good faith and fair dealing).

#### IV. FINAL THOUGHTS: A NORMATIVE JUSTIFICATION FOR THE REIMBURSEMENT RIGHT

To this point, this Article has examined whether the insurer's claim for a right to reimbursement of defense costs incurred in defending noncovered claims can be grounded in sound legal doctrine, and the answer given is yes. A remaining question, among several others,<sup>230</sup> is whether this answer is a good one. If allowing insurers to seek reimbursement of defense costs incurred for defending noncovered claims is a bad idea, the foregoing discussion demonstrates that there is plenty of room for courts to articulate rationales, even if they are doctrinally flawed in one respect or another, that will deny the insurer that right. The normative inquiry must go beyond the issues presented in cases where the insurer claims and the insured resists a reimbursement right. In such settings, the battle lines are already drawn, and the arguments to be advanced are predictable. Rather, the inquiry must be whether the reimbursement right should be part and parcel of the bargain struck between insurer and insured in the liability insurance contract.

Where it is cost-effective for the insurer to assert the reimbursement right, the right's successful prosecution will result in a recovery for the insurer that reduces total claims costs. In this sense, the reimbursement right is closely related to the insurer's subrogation and contribution rights.<sup>231</sup> If an insurer pays proceeds to the insured for a loss caused by and properly attributable to a third party, the insurer's assertion of subrogation rights not only enables the loss to fall on the party who caused and bears responsibility for it, but also reimburses the insurer for the proceeds paid to the insured, thereby reducing the insurer's total claims costs. If an insurer pays a claim to an insured which is also covered by another insurer's policy, the insurer's assertion of a contribution right against the other insurer reimburses the insurer for sums expended in compensating the insured for a loss, thereby reducing the insurer's total claims costs. Of course, just because a right to reimbursement, contribution, or subrogation exists, it does not follow that it is efficient for the insurer to pursue it. In many situations, the costs of prosecuting the claim outweigh foreseeable benefits, and in that event the claim should not be pursued. With respect to subrogation and reimbursement in particular, the possibility that the person whose financial participation is being sought will have no or extremely limited resources is a real one, and pursuing a valid claim against an insolvent defendant makes little sense. In such circumstances, policyholders

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230. See *supra* note 13.

231. For more discussion of subrogation, see JERRY, *supra* note 1, § 96, at 600–27. Contribution is most commonly employed in the “other insurance” clause context. See *generally id.* § 97, at 627–51. Subrogation and contribution are equitable remedies which are, of course, closely related to restitution. See 1 DOBBS, *supra* note 54, § 4.3(4), at 604 (“Subrogation is another equitable remedy in which tracing is used to prevent unjust enrichment and to give effective relief to the plaintiff.”); *id.* § 4.3(4), at 607–08 (“The right to contribution from a co-obligor is also an equitable restitutionary claim which is enforced to prevent unjust enrichment.”); 1 PALMER, *supra* note 54, § 1.5, at 21–24, 29–33.

will not want the right to be pursued, instead preferring that the insurer save the expenses of doing so.

To the extent it is cost-effective to pursue reimbursement and thereby reduce total claims costs, the insurer should be able to offer less expensive liability insurance to policyholders. This ability is meaningless if insureds do not desire less expensive liability insurance, but it is reasonable to assume that, all other things being equal, insureds prefer to pay less for coverage. Of course, some insureds may prefer more elaborate coverage—specifically, defense insurance pursuant to which the insurer bears the cost of defending noncovered claims.<sup>232</sup> But unless all insureds prefer more elaborate coverage over less expensive coverage, which cannot even be known if insurers are foreclosed in the first instance from offering less expensive insurance alternatives, courts should not adopt default rules that preclude the offering of less expensive liability insurance products. On the contrary, the default presumption should be a rule that enables the offering of cheaper insurance, leaving it to the market to discover whether insureds prefer only the offering of more extensive—and more expensive—coverage. Thus, the default legal rule should allow reimbursement rights to be created and enforced; if insureds prefer that insurers not have this right and are willing to pay the higher premium associated with higher claims costs, the market will produce this product.

Indeed, it may be that there is sufficient demand in the market to support multiple products—liability insurance with a reimbursement right, and more expensive liability insurance without a reimbursement right. In fact, if one assumes the absence of costs associated with product differentiation, insurers should offer both products. Because insureds do not expect *ex ante* defenses for noncovered claims<sup>233</sup> and because some insureds will not want to subsidize the defenses of other policyholders for noncovered claims, one would anticipate a viable market for the less expensive product. Once, however, the costs of product differentiation are taken into account, it may be that the expenses associated with drafting clearly differentiated policies and explaining their ramifications to insureds will outweigh the premium reductions that can be offered those who prefer the less expensive liability insurance with a reimbursement right. If this is the case, the market should settle upon the product that is preferred by most policyholders. To enable this sorting to occur, however, courts should give the market the flexibility it needs to facilitate this choice. To that end, courts should apply the relevant legal doctrines in a manner that supports insurers' efforts to reserve rights to seek reimbursement of costs incurred in defending noncovered claims.

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232. See *supra* note 42.

233. This does not mean that defense insurance for some claims not covered by the insurer's indemnity obligation is inefficient in all circumstances. See *supra* note 42.



